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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 570

ALBERT GORDON MACRAE and SHEILA MACRAE,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

JEROME B. ROSENTHAL
250 N. Canon Drive
Beverly Hills, California
Counsel for Petitioners

BERNARD SPEISMAN
Of Counsel

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—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The petitioners pray that a writ of certiorari issue to review judgments of the United States Court of Appeals for the Ninth Circuit, entered in the above-entitled case.

Opinions Below

The findings of fact and opinion of the Tax Court (R. 26) are officially reported (see 34 T.C. 20). The opinion of the Court of Appeals for the Ninth Circuit is not yet officially reported. Both opinions are reprinted in the Appendix hereto.

Jurisdiction

The judgment of the Court of Appeals was entered on August 28, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254.

Statutes Involved

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

Statement of Facts

The facts material to this petition may be summarized as follows:

The petitioners, husband and wife, filed joint returns on the cash basis for the taxable years 1952 and 1953. The transactions at issue herein were transactions of the petitioner husband and he is referred to hereinafter as the petitioner. The petitioner is a well-known entertainer. His business and financial matters were handled for him by his attorneys (R. 27).

In December of 1952 B. Gerald Cantor, president of Cantor, Fitzgerald & Co., Inc. (hereinafter called "C-F"), brokers and dealers in securities, discussed with the petitioner's attorneys the possibility that some of the latter's clients might purchase United States Treasury Notes with a small down payment, using borrowed funds for the bulk of the purchase price. Shortly thereafter, one of the peti-

tioner's attorneys advised him that he could purchase one million dollars in Treasury notes primarily with borrowed money, and that the interest on the loan would be a "good tax deduction." The petitioner was further advised that a profit reportable as a capital gain was possible, and that the loan could be made on a nonrecourse basis (R. 27-28).

Petitioner expected to realize a tax saving through the transactions. He also understood that there might be a profit apart from taxes (R. 65, 93).

On December 19, 1952, with settlement date of December 26, petitioner placed with C-F an order to purchase for his account 1⅜ per cent Treasury notes, maturing March 15, 1954, in the face amount of one million dollars. The confirmation slip of C-F showed the price as $992,500, with accrued interest of $3,874.31. Thereupon the petitioner issued a check in the amount of $3,874.31, which C-F received on or about December 26, 1952. Petitioner also executed and delivered to C-F his promissory note in the amount of $992,500, dated December 26, 1952 and due March 15, 1954, with interest at 2½ per cent per annum. The taxpayer's note was without personal liability and was limited to the collateral security, consisting of the Treasury notes. It provided that petitioner might sell the Treasury notes at any time and discharge the indebtedness by payment of the net proceeds received. He might also anticipate payment by paying additional interest of ½ per cent per annum prorated to the maturity date of March 15, 1954. The note further recited that petitioner had paid the interest, due and to be due, concurrently with the execution of the note and gave C-F a lien against the securities pledged for the principal amount of the note. C-F was to have the right to "rehypothecate or borrow the said securities, provided however, that such rehypothecation or borrowing shall not be inconsistent in any manner with the ownership"

by the petitioner of the securities. The petitioner was to have the right "to obtain the return of said securities in kind at any time upon tender of payment of the principal indebtedness due" under the note (R. 28-29).

C-F purchased $2,000,000 in such Treasury Notes from C. F. Childs, a dealer in such securities, which amount included the $1,000,000 of Notes ordered by petitioner. Subsequently on the same day, C-F sold $2,000,000 of the same Treasury Notes which it had purchased for petitioner. The sales were made for C-F's own account (R. 177). C-F gave petitioner no notice of its sales of the securities and he did not know at any time that C-F intended to make such sales or that it had made them, and, perforce, he gave no order for such sale (R. 82, 91-92).

C-F borrowed petitioner's securities to make delivery against its sale. The "borrowing" of securities is a regular practice among dealers and brokers in securities (R. 29-30).

On December 26, 1952, the taxpayer issued to C-F a check in the amount of $30,257.42, as interest to March 15, 1954 (R. 30).

On or about January 26, 1953, petitioner's loan owing to C-F was refinanced through Gibraltar Financial Corporation (hereinafter called "Gibraltar") of New York City. C-F arranged for this refinancing (R. 101). Petitioner executed a new note under which Gibraltar was substituted for C-F as payee, the nonrecourse feature was eliminated, the interest rate was reduced from 2.5 per cent to 2.42 per cent, the amount of the "loan" was increased from $992,500 to $1,020,000 (face value of the Notes plus interest coupons), and the right to a refund of a portion of interest upon prepayment was eliminated (Exh. 7).

On the same day, petitioner issued his check to C-F, as correspondent for Gibraltar, in the amount of $27,930.11,

as interest to March 15, 1954, on the new note. At the same time, he received a check from C-F in the amount of $28,082.08 as refund of interest on cancellation of the old note (R. 17).

Under the terms of the new note, the $1 million in Notes was pledged as collateral security. In accordance with this arrangement, petitioner directed C-F to deliver the Notes to Gibraltar against payment of $1,020,000. Gibraltar was a correspondent for C-F in New York City. Dealings between such correspondents are reflected in Omnibus accounts (or reciprocal accounts). In accordance with the customary practice in such case, C-F's obligation to deliver the $1,000,000 of petitioner's Notes to Gibraltar was properly recorded in the respective accounts, with the reciprocal obligations of the two firms being balanced off (R. 141, 166-167).

On August 12, 1953, petitioner directed C-F to sell the foregoing $1,000,000 face value of Notes. C-F effected a sale in due course and confirmed the sale of such notes at a total price of $1,001,891.98, including accrued interest in the amount of $5,561.98 (Exh. 25-4). Petitioner authorized C-F to receive the Notes from Gibraltar against payment, and on the same day instructed Gibraltar to deliver the Notes to C-F against payment (Exhs. 11, 18).

In order to comply with petitioner's order to deliver against payment, Gibraltar purchased for its own account $1,000,000 face value of United States Treasury 1⅜ per cent notes due March 15, 1954 and directed the delivery of such notes to the Chemical Bank & Trust Company (hereinafter called "Chemical") as clearance agent for C-F against payment of $1,001,891.98 (R. 191-2, Exh. 11). Petitioner did not direct the purchase of such Notes by Gibraltar and was not aware that Gibraltar had made such purchase. Petitioners reported in their income tax return for

the year 1953 a long term capital gain in the amount of $3,125.00 arising from the sale of the $1,000,000 U. S. Treasury 1⅜% notes (Exh. 2).

Petitioner made further purchases of securities in 1953, as follows:

On March 10, with settlement date of March 11, petitioner ordered C-F to purchase for his account $2 million face amount 1¾ per cent Federal Land Bank Bonds (hereinafter called "Bonds"), due October 1, 1955-1957, and to deliver them to Gibraltar against payment of $1,925,555.56, the price of C-F's purchase (Exh. 25-1). Thereupon, petitioner executed and delivered to Gibraltar his full-recourse promissory note in the amount of $2,104,000, bearing interest at the rate of 4¼ per cent per annum, payable October 1, 1955, and renewable to October 1, 1957, with interest at the rate of 2¼ per cent per annum for any such extended period (Exh. 8).

The note recited that petitioner had pledged the Bonds with Gibraltar as collateral security, and that $178,444.44 of the principal amount of the note would be withheld as security for interest, to be released as interest payments were made. Prepayment to September 1, 1955, was permitted at the rate of 1½ per cent from date of prepayment to maturity.

Gibraltar obtained the $1,925,555.56 which it paid out against these Bonds hypothecated by petitioner by selling equivalent bonds short for its own account and on its own initiative, and delivering petitioner's bonds against its sale (R. 162-163, 191-192). Neither petitioner nor his attorney had directed any such short sale by Gibraltar and neither was aware that any short sale was contemplated by Gibraltar in handling the loan or that any was made (R. 82, 91-92).

On August 12, 1953, petitioner directed the sale of these Bonds and such sale was confirmed by C-F to petitioner at a total amount of $996,250, plus accrued interest. Petitioner directed Gibraltar to deliver the bonds to C-F against payment of the amount owed to it (Exh. 11), and Gibraltar purchased equivalent bonds in the open market for its own account and directed delivery to the clearance agent for C-F against payment. Petitioner had not directed such purchase by Gibraltar and was not aware of it (R. 82, 91-92, 191-193).

On August 13, 1953, and October 30, 1953, petitioner entered into essentially similar transactions involving $1 million face amount U. S. Treasury Notes 1¾% due December 15, 1955, and $1 million face amount U. S. Treasury Notes 1½% due April 1, 1958, respectively (Exhs. 25-1, 25-2). Petitioner executed and delivered to Gibraltar full-recourse notes similar to that covering the Bond transaction, in the respective principal amounts of $1,043,250 with interest at 2⅞% and an interest reserve of $54,178.96 and $107,067,000 with interest at 2¾% and an interest reserve of $94,554.95 (Exhs. 9, 10). Subsequent to the taxable years in issue petitioner closed out these transactions by directing the sale of the Notes and such sale and delivery were effected in essentially the same manner and circumstances as in the case of the 1⅝% Notes and the Bonds.

During 1953, petitioner issued checks in the net amount of $132,632.12 to Gibraltar representing interest due on its notes (Exh. 3, R. 16-17).

During 1953, petitioner received various amounts from C-F, both on its own and on Gibraltar's account, representing interest accrued and due on the various Notes and Bonds which he had purchased and which he owned. Petitioner reported $34,094.82 in his 1953 return as interest income (R. 17).

Petitioner intended to purchase the United States Government obligations, above described, and to borrow the various amounts evidenced by his notes given to C-F and Gibraltar in order to pay the bulk of the purchase price of the securities so purchased. He gave the orders to purchase the securities and signed the aforesaid notes solely with such intention to purchase securities and to remain the owner thereof until he sold them, notwithstanding the hypothecation of the securities to secure the said loans. The notes which he gave to the lenders state that petitioner was entitled "to obtain the return of said securities in kind at any time upon tender of payment of the principal indebtedness due" under the note (R. 28-29).

Questions Presented

1. Is it proper, in applying Section 23(b), 1939 I.R.C., to indebtedness incurred in transactions of a commercial nature, as distinguished from transactions of a purely personal nature, to deny deduction of interest paid on such indebtedness merely because the transaction may have provided no "reasonable" chance of profit apart from the tax consequences, or merely because the taxpayer's sole, or main, motive in entering the transactions may have been tax reduction?

2. In applying Section 23(b), 1939 I.RC., is it proper to consider the effect of Section 117, 1939 I.R.C., relating to the taxation of capital gains and losses, on the overall transaction which gave rise to the indebtedness; or must the interest deduction (Section 23(b), 1939 I.R.C.) be allowed as long as real, enforceable indebtedness has been created, without regard to the tax consequences of the transaction as a whole?

3. May a taxpayer who is one party to a contract be held responsible for the independent acts of the other party, which are not required by the terms of the contract, expressly or by implication, and of which the taxpayer had no knowledge? Specifically, where a taxpayer buys securities and pledges same for a purchase money loan and the lender sells the same type of securities short for its own account, borrowing the taxpayer's securities to make delivery, may such short sales be attributed to the taxpayer-borrower so as to negative his continuing ownership of the securities and the indebtedness based thereon, even though the short sale was not required or contemplated by the terms of the contract and the borrower had no knowledge of the lender's purpose to make a short sale or of the fact of the sale?

4. Were the provisions of Section 23(b), 1939 I.R.C. correctly applied in this case?

Reasons for Granting the Writ

Preliminary Statement

Two bases of decision appear in the Tax Court's opinion in this case, to which the Court of Appeals gave blanket approval.

First, the Tax Court found petitioner's transactions had an "essential nullity", apparently because the lender, with which petitioner hypothecated securities for purchase-money loans, sold equivalent securities short and borrowed petitioner's securities to make delivery against its sale, thereby providing the lender with funds to finance the loans to petitioner.

Second, the Tax Court concluded petitioner's loans were not "indebtedness" within Section 23(b), but were "shams"

because petitioner purported to enter into the transactions as "hard-headed commercial transactions for profit", yet "no reasonable chance existed of realizing a profit" apart from the tax consequences.

Petitioner believes these two conclusions reflect errors of law and involve direct conflicts with decisions by other Courts of Appeal and of this Court; also, that the instant decision involves important questions of Federal tax law which have not been but should be settled by this Court.

These errors are patent in the findings and opinion of the Tax Court. For one, the Tax Court ascribed the lenders' short sales to petitioner although it found, generally, that "dealers and brokers will hold securities as collateral and when necessary, borrow securities so held to cover short sales"; also, and more particularly, that petitioners "had no actual knowledge of the mechanics of the transaction as undertaken by (the lenders)."

Second, the Tax Court inconsistently held the transactions herein were "shams" under Section 23(b) because no reasonable opportunity for profit existed, while agreeing that the unqualified word "indebtedness" in Section 23(b) embraces personal debts incurred without profit motive or opportunity.

The errors of the decision in this case are brought into focus when the Tax Court's approach and rationale in this case are compared with that in another similar case decided by it five days earlier. The inconsistency of the Court's rationale in the two cases, each concerned with the meaning of "indebtedness" as used in Section 23(b), can only be construed as indicating that the instant case has not been decided with due regard to controlling principles of law.

I. The instant decision creates a conflict among the Courts of Appeal as to whether a profit motive or opportunity is a necessary condition to the allowance of the interest deduction under Section 23(b), 1939 I.R.C.

The Tax Court made a vital determination of law in this case, with blanket approval by the Court of Appeals, which is in conflict with prior holdings of the Court of Appeals for the Second Circuit and with the plain meaning of governing Section 23(b), 1939 I.R.C. This determination of law is confused in an ostensible finding of fact—that petitioner's transactions were "sham"—but its true character and its lack of validity are unmistakable.

The petitioner, Gordon MacRae, testified candidly at the hearing that a substantial reason for entering into the transactions at issue was to effect a tax saving, although he also hoped to (and had a chance to) realize a profit apart from taxes. Petitioner argued in his briefs below that as long as the indebtedness created by petitioner was bona fide, interest paid thereon is deductible under Section 23(b); that his motive in entering into the transactions which gave rise to the indebtedness is immaterial since no business or profit motive is required under the terms of Section 23(b). Thus, interest on indebtedness to buy a family residence or to take a vacation, etc., etc., has always been recognized as being deductible.

Addressing itself to this crucial contention by petitioner, the Tax Court stated at the end of its opinion:

> "Had petitioners in fact borrowed money for a vacation, or for any other purely personal purpose, they would clearly be entitled to a deduction for any interest paid on such loan, and we do not understand respondent to contend otherwise. We must first, how-

ever, determine whether petitioners in fact incurred a bona fide indebtedness regardless of their reasons for doing so. We are forced to conclude in the light of the entire record that they did not.

"Petitioners did not purport to borrow funds for personal reasons, but rather in respect of hard-headed commercial transactions for profit. They acted within the formal framework of such premise, and it is in the light of the nature of the transactions as claimed by them that we must determine the reality or lack of it in what they did.

"Petitioners have purported to enter into a profit-seeking transaction. Yet under the circumstances, no reasonable chance existed of realizing a profit, apart from the 'tax gimmick' feature of the transactions the very aspect in which they were originally presented to and found acceptable by petitioners. *It is for this reason* that we conclude that the transactions in question, the reality of which may be sustained only on the theory that they were commercial undertakings for profit, were shams, and must be disregarded for tax purposes. Accordingly, respondent's determination is here sustained. Cf. L. Lee Stanton, 34 T.C. —— (filed April 7, 1960)." (Emphasis added.)

Manifestly, this statement differs from the usual determination of "sham" in tax cases, which signifies that a transaction is other than it purports to be purely as a matter of fact—that it pretends to be what it is not. Here, the Tax Court is labelling the transaction a "sham" not because it is other than it purports to be, but rather because the transaction does not, as a matter of law, qualify under the requirements of Section 23(b), 1939 I.R.C., as the Tax Court interprets that Section.

In essence, the Tax Court has held this: The word "indebtedness" as used in Section 23(b) encompasses money obligations incurred for personal, non-profit, purposes such as for a "fly now pay later" vacation. But if an indebtedness is incurred in a "commercial transaction," it does not qualify if no reasonable chance existed of realizing a profit" apart from the tax consequences. "*It is for this reason*", the Court stated bluntly, that the transactions in question "• • • were shams and must be disregarded for tax purposes." (Emphasis added.)

This is not a factual determination that the transactions at issue were other than the purchases of securities and the borrowing of the purchase price that they purported to be. It is, rather, a naked conclusion of law that the borrowing does not qualify as "indebtedness" under Section 23(b) because petitioner entered into the transaction of purchasing securities without any reasonable chance of profit apart from the effect of tax law on the transaction; in other words, because petitioner entered into the transactions solely or mainly to minimize his taxes.

This determination of law has far-reaching implications with respect to the application of Section 23(b) (as well as its exact counterpart, Section 163, 1954 I.R.C.). It is clearly erroneous, and the decision based thereon, as fully approved by the Court of Appeals for the Ninth Circuit, is in direct conflict with the decision of the Court of Appeals for the Second Circuit in *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118, revg. 21 T.C. 513, which held that valid indebtedness qualifies under Section 23(b) even though the sole or principal purpose of creating the indebtedness was tax minimization, without any commercial purpose. This issue, which has never been decided by this Court, is the crux of the instant case.

In interpreting a word in a statute, it is manifestly improper to give it one meaning in one case and the opposite meaning in another. Yet that is what the Tax Court has done here, in effect, in recognizing that "indebtedness" in Section 23(b) embraces personal debts lacking both profit motive and profit opportunity and at the same time holding that petitioner's indebtedness was "sham" because the transactions from which it arose provided no reasonable expectation of profit. Congress did not create two separate classifications of indebtedness in Section 23(b) with different tests applicable to each. It used only the single unqualified word "indebtedness" as a test and if "indebtedness" is construed to mean that profit motive is not necessary in some kinds of transactions, that is what it must mean in respect of all transactions.

Thus, it is wholly immaterial under Section 23(b) that "petitioners have purported to enter into a profit-seeking transaction." All that is material is whether petitioner entered into real, enforceable transactions of purchasing securities and borrowing money to pay the purchase price. When Congress intended to include a profit test in a deduction provision, it said so explicitly, as in Section 23(e), 1939 I.R.C., referring to losses incurred in "transactions entered into for profit," etc. It included no similar test in Section 23(b) and the premise upon which the Tax Court sought to label petitioner's transactions as sham, namely, that petitioner "purported to enter into a profit transaction", is, thus, false and irrelevant to the application of Section 23(b).

Even granting, *arguendo*, the Tax Court's postulate that "it is in the light of the nature of the transactions"—i.e., as "hard-headed commercial transactions for profit"—"that we must determine the reality or lack of it" in petitioner's transactions, and granting, *arguendo*, that there

may be transactions which create enforceable legal rights as between the parties thereto yet may not be real for the purpose of Section 23(b), the question posed by this case is this:

> May *reality* for the purpose of Section 23(b) be defined so as to exclude from its purview, indebtedness incurred at arm's length terms in transactions such as the petitioner herein consummated, involving the purchase of negotiable securities issued by the government of the United States on the regularly constituted market therefor, through a regularly established broker which is a member of the National Association of Securities Dealers and subject to regulation and supervision by that body and by the Securities and Exchange Commission?

This describes a normal transaction entered into daily by thousands of American citizens through brokers and banks which is surely of the very essence of reality and is recognized as such by the respondent for the purpose of Section 23(b) and otherwise. It also describes petitioner's transactions within the postulate of the Tax Court. It is *only* on the Tax Court's finding that this petitioner, in exercising his legal right to purchase the securities at issue and to borrow money at a normal rate of interest to pay the purchase price, had "no reasonable chance of profit" apart from the *normal tax consequences* (which the Court labels a "tax gimmick")—it is expressly *on that ground alone*—that the Court calls petitioner's transactions "shams".

That, petitioner submits, is not a finding of lack of reality in petitioner's transactions as such, but a determination of law that those real transactions do not qualify under Section 23(b), as the Court interprets that provision, *only*

because it finds "no reasonable chance of profit • • •." This determination is in direct conflict with the decision of the Court of Appeals for the Second Circuit in the *Kraft Foods Company* case, supra.

In the *Kraft Foods Co.* case, supra, the taxpayer corporation issued $30,000,000 in its debentures to its parent corporation in payment of a dividend declared out of surplus. It thereby expected to obtain a deduction for the interest paid on the indebtedness, to replace the credit for dividends paid to its parent, the right to which Congress had repealed a short time before. In denying deduction of the interest paid on these debentures, the Commissioner argued that transactions "though formally perfect and in compliance with a provision of the tax statute must be disregarded if they have no purpose germane to the conduct of the business other than tax minimization."

Rejecting the Commissioner's argument, the Court of Appeals noted that it is established that, "transactions even though real, may be disregarded if they are a sham or a masquerade • • •," but: "The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be is in fact • • •." Pointing out, further, that the taxpayer and its parent corporation had engaged in certain objective acts with the intent of creating legal rights and duties and that the occurrence of these acts affected their legal relations, the Court allowed the deduction of the interest paid by the taxpayer in accordance with its legal obligation.

In the instant case, petitioner directed the purchase of securities, and this was in fact done on the open market. Petitioner became the owner of the securities and he borrowed the purchase price. Under the principle of the *Kraft Foods* case, this was sufficient to create "indebtedness" within Section 23(b), irrespective of petitioner's mo-

tive to make a profit or to minimize taxes. It was sufficient if the transactions themselves created the intended legal rights with whatever opportunity for profit legal ownership entailed under the circumstances. However, the instant case holds, in essence, that petitioner's transactions do not qualify, irrespective of the valid legal rights and obligations created thereby, because petitioner entered into commercial transactions for profit, without having any reasonable chance of profit—i.e., solely for the purpose of tax minimization. This case is, thus, in direct conflict with *Kraft Foods Co., Inc.* v. *Commissioner*, supra.

This case is also in essential conflict with a decision by the Court of Appeals for the Second Circuit, holding that interest on personal indebtedness is deductible under Section 23(b).

> *William P. T. Preston* v. *Commissioner*, C.A. 2, 132 F. 2d 63, rev'g 44 B.T.A. 973.

The main question thus presented to this Court is this:

> In applying Section 23(b) to indebtedness incurred in transactions of a commercial nature, as distinguished from transactions of a purely personal nature, is it proper to deny deduction of interest paid on such indebtedness merely because the transactions may have provided no "reasonable" chance of profit apart from the tax consequences—or merely because the taxpayer's sole or main motive in entering the transactions was tax reduction?

A corollary question, which is implicit in the Tax Court's approach in this case, is this:

> In applying Section 23(b), is it proper to consider the effect on the transaction of Section 117, relating to the taxation of capital gains and losses, or must the

interest deduction be allowed as long as real, enforceable indebtedness has been created, without regard to the tax consequences of the transaction as a whole?

Restatement of a few basic facts of the case will put these questions into proper perspective. Petitioner purchased early maturity obligations of the United States yielding approximately 1½ per cent interest per annum. To carry these securities, he borrowed money at 2½ per cent per annum. Just prior to maturity, approximately 15 months after he purchased the securities, petitioner sold the securities, realizing a profit which he reported as a capital gain. The natural possibility had existed that the price of the securities which he purchased would rise, due to a decline in interest rates or other economic factors, in due time to give petitioner a profit apart from taxes. If this did not eventuate, petitioner was advised, and he believed, that he would profit in so far as his excess interest cost (over yield realized) would reduce income subject to high surtax rates and his ultimate profit on sale of the securities would be subject only to a 25 per cent capital gains tax.

It is manifestly this translation of the excess interest cost into a net profit through the operation of the capital gains tax which has caused the denial of the interest deduction in this case. Obviously, when the Tax Court weighed petitioner's chance of realizing a profit in applying Section 23(b), it was tacitly considering Section 23(b) not as an independent provision of the Code allowing the deduction of interest on (real) "indebtedness", but as if Section 117 imposed a limitation on Section 23(b). But no such limitation appears in Section 117 or in Section 23(b), as is the case in other instances where Congress intended one provision to act as a limitation on another—as in Section 23 (a)(1)(B) or in Section 23(p)(1), each expressing a different limitation on Section 23(a)(1)(A).

Moreover, profit expectation is too subjective to serve as a valid test. A novice might anticipate a profit in a situation from which an expert would shrink—and yet the novice could prove to be the real "expert" in the end. With uncertainty an inevitable factor, reasonableness of profit expectation is a treacherous as well as irrelevant basis to determine whether the interest deduction is allowable, inviting the application of hindsight in determining reasonableness. This may already have been demonstrated, in the case of *L. Lee Stanton*, 34 T.C. 1 (Appendix, page 64), as will appear.

This profit test creates an inevitable threat to potential purchasers of obligations issued by the United States, particularly in view of the uncertainty which it entails, and it, therefore, constitutes a real deterrent to the marketability of such securities which could conceivably affect the fiscal operations of the United States Treasury.

The problem is not confined to cases like this one, financed by the lender through a short sale, but touches the entire area of government bond dealings on credit. This is readily apparent in the case of *L. Lee Stanton, supra*. There, the taxpayer purchased $5,000,000 face value of United States Treasury Notes bearing 1½ per cent interest coupons for $4,921,968.75 (plus accrued interest of $21,644.01) during June and July 1953. Stanton borrowed the full face value of the notes, or approximately $78,000 in excess of their market value from four different banks on his own 3½ per cent term promissory notes, prepaying interest of $151,830.77. Stanton sold the notes for a total of $5,021,187.50 in February, 1954 (plus accrued interest of $25,570.08), after experiencing some difficulty in persuading certain of the banks to accept prepayment of his loans. The Commissioner disputed Stanton's right to deduct the interest paid on this indebtedness.

The Tax Court upheld Stanton, allowing deduction of the interest paid on his indebtedness to the banks. The Commissioner did not appeal the *Stanton* case. It is significant, however, that he is continuing to contest like cases involving the hypothecation of United States obligations by high-bracket taxpayers at banks. See *Clifford E. Hood, et ux.*, T.C. Memo, No. 1961-231.

Thus, manifestly, the fiscal and tax problems posed by the instant case have not been set at rest—including the inevitable deterrent to purchases of United States obligations. Rather, the Commissioner's actions in the *Stanton* and *Hood* cases suggest that such a deterrent may suit the Commissioner's ends only too well. To date he has not acquiesced in the *Stanton* case. This, together with his failure to appeal that case and his pursuit of other taxpayers in like position, can only continue the existing confusion and uncertainty as to the meaning of the law.

The issue in this case was not resolved by this Court's decision in *Knetsch* v. *Commissioner* (1960), 364 U.S. 361. That case did not involve the purchase of property, such as is present here. The essence of the decision in the *Knetsch* case, supra, is that what purported to be an insurance contract of $8,388,000, on its face actually amounted to a commitment of $1,000 due to the taxpayer's own annual borrowing of the full amounts available under the policies. Accordingly, this Court ruled that Knetsch's transaction did " 'not appreciably affect his beneficial interest except to reduce his tax * * * ' ".

In the instant case, petitioner directed the purchase of securities which had a fixed market value, and became obligated to pay the purchase price. Petitioner undertook the full risk of ownership of the securities and *his* beneficial interest was affected to the full extent of their cost.

The particular questions in this case are, thus, outside the scope of the *Knetsch* case. The Court of Appeals appears to have recognized that in the instant case. Although its decision refers to the *Knetsch* case, it was merely by reference its decision in *Kaye* v. *Commissioner*, 287 F. 2d 40. Petitioner can detect no intimation of any reliance on *Knetsch* in the Court of Appeals' decision in the instant case.

II. The instant decision creates a conflict with applicable decisions of this Court and of the Courts of Appeal respecting the question whether a motive to minimize taxes invalidates an otherwise valid transaction.

In stressing the taxpayer's motive, however obliquely, rather than the reality of what the taxpayer did, the instant decision is in conflict with a long line of decisions by this Court and the Courts of Appeal holding that the motive to reduce or minimize taxes does not invalidate otherwise legitimate transactions for the tax purposes.

> *Gregory* v. *Helvering*, 293 U.S. 465, 469;
> *Chisholm* v. *Commissioner*, C.A. 2, 79 F. 2d 14, 15;
> *Sawtell* v. *Commissioner*, C.A. 1, 82 F. 2d 221, 222;
> *Commissioner* v. *Veiser*, C.A. 6, 75 F. 2d 956, 958;
> See also *Kraft Foods Co.* v. *Commissioner*, *supra*, 127, 128, and cases therein cited.

That the motive to avoid taxes is not sufficient to invalidate an otherwise real transaction for tax purposes has been settled beyond any doubt. This has most recently been demonstrated in cases which have allowed a purchaser of bonds the right to amortize the premium on the bonds although the bonds are donated to charity shortly after

their purchase, even though this entails a double deduction of the premium (by way of amortization deduction).

Maysteel Products, Inc. v. *Commissioner*, C.A. 7, 287 F. 2d 426;
Fabreeka Prods. Co. v. *Commissioner*, C.A. 1, —— F. 2d ——, Oct. 5, 1961;
T. M. Evans, et al. v. *Dudley*, C. A. 3, —— F. 2d ——, Nov. 8, 1961.

III. The Tax Court has introduced inconsistencies into its decisions on this issue which indicate a failure to apply pertinent principles of law to petitioner's case. Adoption of the Tax Court's rationale in this case by the Court of Appeals raises two important issues which have not been, but should be, settled by this Court.

A. The Tax Court's inconsistency in applying a profit test under Section 23(b), 1939 I.R.C., as approved by the Court of Appeals in the instant case, places that test in the posture of an issue never passed upon but requiring consideration by this Court.

That the Tax Court upheld Mr. Stanton's right to deduct the interest which he paid to the banks while denying the same right to petitioner five days later on substantially similar facts necessitates a comparison of the two cases. Such a comparison reveals two significant focal points: (a) the application of the profit test, and (b) the respective lenders' methods of financing the loans.

As to the profit element, it must be noted that Lee Stanton did not realize a pre-tax profit from his transactions any more than the petitioner herein did. Such a profit was actually possible for Stanton at one point, but several of the banks refused to refund any of the prepaid interest at that time.

In contrast with its position in the instant case, the Tax Court, in the *Stanton* case, could find no profit requirement in Section 23(b):

> "• • • Congress has included no requirement in the Code that the borrowed money be used in connection with a transaction entered into for profit or that it cannot be borrowed for personal or nonbusiness purposes or used in a transaction involving tax benefit • • •".

The Court found that the clear and convincing legislative history of Section 23(b) supported this position.

At another point, the Tax Court had this to say in *Stanton*:

> "The Internal Revenue Code imposed heavy taxes on Lee and he sought a legal way within the provisions of the Code to make a profit for himself *after taxes*, the only kind of profit which can do any taxpayer any good." (Emphasis added.)

Noting further, that Stanton "had reasons, which seemed sufficient to him at the time" to believe the banks would accept prepayment of the loans, the Court concluded:

> "What reason is there for penalizing Lee and deviating from the plain words of the Internal Revenue Code merely because the unexpected action of the banks wiped out Lee's real gain by requiring him to pay about $126,000 of additional interest?"

Thus has the Tax Court, in a single paragraph, (a) avowed that profit before taxes is not essential under Section 23(b), and, (b) hastened to emphasize that Stanton did have an actual profit (if only the banks had waived $126,000 of interest to which they had a valid right at law).

Thus too, within a period of five days, has the Tax Court (in a reviewed decision joined by 12 of the 16 judges) ruled in the *Stanton* case that a profit before taxes is not essential under Section 23(b) and then in the instant case, that petitioner's transactions were "sham" because "no reasonable chance existed of realizing a profit apart from the 'tax gimmick' feature of the transactions * * *."

No less incompatible with its holding in the instant case is the weight given by the Tax Court to the fact that Stanton might have had (but actually did not have) a pre-tax profit. The test laid down in the instant case was "chance" of profit. No mention was made of that test in *Stanton*. This is an interesting disparity. For, while the Court concluded that the petitioner herein had no reasonable expectation of profit, the facts demonstrate that he had at least twice the expectation of profit, objectively viewed, that Stanton could have had. Whereas petitioner paid 2½ per cent interest on his borrowing, Stanton paid 3½ per cent. Thus, Stanton had approximately double the excess interest cost (over the approximately 1½ per cent yield of the bonds) to overcome before he could realize a pre-tax profit that petitioner had!

The fact that Stanton could have realized a pre-tax profit in these circumstances simply demonstrates that such an opportunity existed for petitioner as well, since petitioner purchased the same type of bonds as Stanton, under more favorable terms.

This inconsistency of rationale reflected in the two cases can leave only doubt that the Tax Court has been able to decide the issue by reference to appropriate and valid principles. What effect an *actual* profit test for the interest deduction, such as the Court appears to have entertained in the *Stanton* case, would have on the securities markets,

with their large quotient of credit transactions, can only be left to the imagination. How many people would be anxious to buy United States Government bonds and notes if they knew in advance that the interest paid on borrowing for the purchase would not be tax-deductible unless an actual profit was made?

An actual profit test is manifestly untenable, but where would Stanton be if the same test of profit expectation, or "chance", had been applied to him as was applied to the petitioner herein?

The blanket approval of the Tax Court's decision by the Court of Appeals in this case sanctions the inconsistency of the Tax Court's rationale and holding herein. It raises an important question—whether profit is a proper factor for consideration in applying Section 23(b), and if so, on what basis. This question is fundamental in the application of the Internal Revenue laws. It has not been but should be settled by this Court.

B. The Tax Court's inconsistency (approved by the Court of Appeals) in attributing the independent lender's short sale to the petitioner (borrower), absent collusion in such sales on the part of petitioner, poses an unsettled issue which should be considered by this Court.

There is one difference in the facts of the instant case and those in *Stanton* which gives rise to another substantial question. That concerns the lenders' resort to the short sale in the instant case. Stanton hypothecated the bonds with banks and there was no evidence whether the banks retained the bonds, rehypothecated them with the Federal Reserve Banks at full face value (as proved in the instant case) or effected short sales. The Commissioner argued in the *Stanton* case that it was controlled by such cases as *Eli D. Goodstein* (1958) 30 T.C. 1178, aff'd per curiam (C.A.

1, 1959) 267 F. 2d 127 etc., in which the lenders had financed through the medium of short sales. Rejecting the Commissioner's contention and distinguishing the *Stanton* case, the Tax Court stated:

> "• • • • The alleged *Goodstein* transactions were *collusive* shams throughout arranged by Eli Livingstone. The Treasury notes were purchased and sold practically as one transaction in which no real money passed on behalf of the taxpayer. • • • " (Emphasis added.)

Petitioner submits that the key word in the foregoing quotation is "collusive". That word is warranted by the facts of the *Goodstein* and the other cases which followed it, all of which were arranged by Eli Livingstone. It is not warranted on the facts and findings of the instant case. Therefore, the instant case is distinguishable from *Goodstein* etc., but cannot be distinguished from *Stanton*, and it is in fact inconsistent with the holding in *Stanton*.

The lender-borrower relationship, *per se*, is ordinarily that of independent contractors; one party lends his money as a principal to the borrower who is likewise a principal to the transaction. However, the facts developed in the *Goodstein* and other cases handled by Mr. Livingstone, a securities dealer in Boston, permitted the inference that such was not the relationship in those cases. The facts show that his customers were informed from the outset how Livingstone expected to handle the transactions. A private ruling by the Internal Revenue Service, which Mr. Livingstone exhibited to his customers as part of his particular sales "pitch", described every aspect of the transactions, including the lender's borrowing of the hypothecated securities. The inference of collusion in a mere "tax gimmick" which necessarily stemmed from the tax-

payer's knowledge of what Livingstone proposed to do was reinforced by the fact that the parties did not behave like ordinary customer and broker effecting a bona fide purchase of securities on margin. Rather, their actions suggest that their only intent was to join in the creation of a facade for tax purposes. In the *Goodstein* case, for example, no amount was credited to the taxpayer's account by the lender on account of interest earned on the Treasury bonds and no interest was reported as income by the taxpayer Goodstein. Nor was any sale of Treasury securities made by the taxpayer when he decided to close out his transactions; only bookkeeping entries were made on the lender's books closing out the account. These facts compel the inference that the parties never intended that Goodstein own any bonds or incur any indebtedness predicated on such ownership, but only that a mere facade be established for tax purposes. Similarly, in the *Lynch* case, 31 T.C. 990, aff'd C.A. 2, 273 F. 2d 867, it appears that no bonds were ever purchased on the market, but only book entries were set up showing an ostensible ownership of bonds. The inference of collusion to create a mere facade of ownership was irresistible in the circumstances.

In the instant case, the government conceded that the form of petitioner's transactions, unlike that in the *Goodstein* case and the *Sonnabend* case (T.C. Memo. 1958—178, aff'd C.A. 1, 267 F. 2d 319), etc., was flawless. No discrepancies appear in the course of dealing in purchasing bonds, borrowing, sale of bonds and repayment.

The Tax Court recognized this "greater perfection of form", but it professed to see no difference in substance. Noting that the results in prior cases such as *Goodstein*, etc., were obtained because the substance of each of the respective transactions differed from its form, the Court concluded that "petitioners here are not aided because this divergence is even greater in their case."

Petitioner maintains that the impeccable form of his transactions while not, in itself, a basis for granting the rights he claims, is simply corroborative proof that he intended to purchase and own the United States Government securities which were actually purchased in his behalf. Surely, petitioner had the same right as any other citizen to purchase such securities on credit. That is what he intended to do, and did, following his attorneys' advice to buy the particular securities and borrow money to pay the purchase price, on the attractive terms which were available, in order to achieve the desired tax saving, because petitioner had everything to gain by performing this simple, practical, action—and nothing to lose; the risk-free character of the securities he purchased, and the unquestionable credit of the United States, insulated him from loss. The impeccable form of petitioner's transactions reflects this simple truth. What he did is merely what everyone does, day in and day out, when they intend to purchase securities on margin, or credit, through a broker. Petitioner did not deal with Livingstone. He was not in privity with Goodstein, Sonnabend, or any other customer of Livingstone. Their patent shams cannot abridge his right to consummate real transactions.

One salient error by the Tax Court is the key to its view of petitioner's case. At one point in the opinion the Court asserts that, "The various purchases and sales, each real without the other, neutralize one another." The inference is plain that the Court meant to attribute the lenders' short sales to the petitioner.

What basis is there for such an action in *this* case? Petitioner dealt with a broker, situated and doing a general securities business with the public in Beverly Hills, California, 3000 miles removed from Mr. Livingstone's headquarters in Boston. The record plainly reveals that this

broker apparently understood that the desired tax consequences depended upon real transactions. Every party to petitioner's transactions took the stand at the hearing in this case (unlike the various "Livingstone cases") and testified, subject to cross-examination, that neither the petitioner nor his representatives were ever advised about the short sale procedure. Petitioner laid great stress on this fact in his briefs before the lower courts, as he does here. With full understanding of the significance which petitioner attached to this point, Judge Forrester, who presided at the hearing of this case, found:

> "Petitioners urge that they had no actual knowledge of the mechanics of the transactions as undertaken by C-F and Gibraltar (the two lenders in this case), *and we believe this to be true.*" (Emphasis added.)

Judge Forrester went on to say that this point had been disposed of in the *Goodstein* case, *supra*. That conclusion is without basis. Goodstein did not claim that he did not know of the mechanics of the transaction, nor could he have claimed this since he had read the ruling which described the short sale procedure in detail. (In fact, he sought unsuccessfully to establish an estoppel on the basis of the ruling.) As the very language quoted by Judge Forrester from the *Goodstein* case shows, Goodstein "testified that he did not give an order for the sale of the Treasury notes, and that he did not know of the sale at the time it occurred."

This is substantively different from petitioner's position, as proved and as found by the Tax Court. The facts respecting the display of the Revenue Ruling and the failure to carry out real transactions of purchase, borrowing and sale of securities in the *Goodstein* case fully warranted the inference that the transactions therein were *collusive*, the basis upon which Judge Murdock expressly distinguished the *Stanton* case from *Goodstein*, etc. Having authorized

the creation of a mere facade, a nullity, it was immaterial that Goodstein did not specifically "give an order for the sale of the Treasury notes," and "that he did not know of the sale at the time it occurred." It was clearly sufficient in law that the acts were performed in accordance with his over-all collusive arrangement.

The proof and the Court's finding in the instant case that petitioner "had no actual knowledge of the mechanics of the transaction" preclude any finding of collusion on the part of petitioner. Indeed, the Court's assertion that petitioner's transactions were a "nullity" because of the lenders' short sales hardly seems consistent with its subsequent conclusion that the transactions were (merely) "shams" only because "no reasonable chance of profit existed" apart from tax consequences.

The important question thus presented by the instant case, for which no precedent appears in Federal tax annals, is this:

> Where a taxpayer buys securities and pledges same for a purchase money loan and the lender sells the same type of securities short for its own account, borrowing the taxpayer's securities to make delivery, may such short sales be attributed to the taxpayer-borrower so as to negative both his continuing ownership of the securities and his indebtedness, even though the short sale was not required or contemplated by the terms of the contract and the borrower had no knowledge either of the lender's purpose to make a short sale or of the fact of his making the short sale?

In general terms:

> May a taxpayer who is a party to a contract be held responsible for the independent acts of the other party, which are not required by the terms of the contract,

expressly or by implication, and of which the taxpayer did not even have knowledge?

The question is important because the result of the decision in the instant case is to put every purchaser of stocks, or other securities on margin on notice that his ownership and the rights incident thereto may be terminated by the independent actions of the broker-pledgee in borrowing his stock.

Petitioner's note authorized the lender to "rehypothecate or borrow the said securities". As unimpeachably proved by petitioner, it is the universal practice in the financial community for brokers and other lenders to reserve the right to rehypothecate or borrow customers' securities held by them on margin. Brokers regularly borrow their customers' margin securities to lend to other customers who may be short such securities, for their own account or to lend to other brokers for their own or their customers' account. In the face of this universal practice, the Commissioner has never been known, heretofore, to claim that the borrowing of a customer's securities by his broker terminates the customer's ownership so that he would have to report a gain or loss at that point, or so that his holding period would end for capital gain purposes.

Petitioner's position is no different. In granting the lender the right to borrow his securities, petitioner did only what all taxpayers are required to do in the same circumstances. The lender could have borrowed petitioner's securities for a variety of purposes, such as for loan to other customers of the lender, or to other brokers for loan to their customers. Nor did anything in the contract require the lender, expressly or by implication, to borrow the securities. It could have rehypothecated the securities, as banks themselves do regularly. The granting of the right to the lender

to borrow the securities, thus, could not have put the petitioner on notice that the lender would sell the same type of securities short in order to carry out its obligations under the loan contract.

The fact that petitioner's motive in entering the transaction may have been mainly or wholly to effect a tax saving does not warrant an inference of collusion or sham. Yet, on the record of this case, that is the effect of the Tax Court's decision.

As the holding in the *Stanton* case shows, it was possible to achieve the tax saving by buying the securities and borrowing the money. That is all petitioner sought to do and that is all that he did do, insofar as any actions which are attributable to him at law are concerned.

It should be noted that the lenders did not have to tell petitioner or his representatives about the short sale. Since the securities at issue were debt obligations, and not equity securities, the lender's risk as a short seller was limited by the $1,000 face value of the securities. (Such securities occasionally rise a small fraction above their face value, but no more.) The lenders did not require the collusion of the petitioner in order to carry out the transaction according to their own designs.

Thus, the Tax Court's finding that petitioner had no knowledge of the lenders' short sales is unavoidable on the record, although the conclusion of law which the Tax Court drew from this fact is erroneous.

As a matter of procedure, petitioner maintains that the Tax Court erred in admitting into evidence, over petitioner's objections, proof that the lenders had sold short for their own account the same type and amount of securities which petitioner had hypothecated with said lenders for the purchase money loans made to him. The short sales

were the independent transactions of the lender and, as such, can have no significance with respect to petitioner's rights. This was substantial error in so far as the Tax Court expressly concluded that such sales rendered the purchases of securities by the petitioner a "nullity."

Fred C. Niederkrome et al. v. *Commissioner*, C.A. 9, 266 F. 2d 238.

No basis appears in the record for admitting such extraneous evidence as an element of respondent's case against this petitioner and, in view of the Tax Court's finding that petitioner did not even know of the short sales, no such basis exists.

The decision by the Court of Appeals herein failed to correct the demonstrated errors of the Tax Court's rationale and holding on this point.

IV. The blunt inconsistencies and contradictions in approach and rationale as between the instant case and the *Stanton* case, supra, demonstrated in Point III, hereof leave the unavoidable inference that the Courts have decided the instant case with such disregard of controlling principles of law as to call for this Court's exercise of its power of supervision.

The inconsistencies and contradictions of the Tax Court's approach and rationale, as demonstrated in Point III, hereof, indicate plainly that the Tax Court and the Court of Appeals have decided the instant case in disregard of controlling principles of law.

No other conclusion is rational when, only five days apart, the Tax Court finds petitioner's transactions were "sham" because "no reasonable chance existed of realizing a profit apart from the 'tax gimmick' feature," and in

another case involving the same issue (*Stanton*), holds that "Congress has included no requirement in the Code that the borrowed money be used in connection with a transaction entered into for profit • • • or that it cannot be used in a transaction involving tax benefits • • • " and deemed it meaningful to state that Stanton had "sought a legal way within the provisions of the Code to make a profit for himself *after taxes, the only kind of profit* which can do any taxpayer any good." (Emphasis added.)

And the foreseeability test applied in the instant case—i.e., "reasonable chance" of profit—contrasts oddly with the hindsight test used in *Stanton* where the taxpayer had but half the chance of profit at the outset that petitioner had.

Nor were these inconsistencies impeded by the fact that the Tax Court was compelled, in *Stanton*, to renounce the rationale advanced by it in four earlier cases. (The revised rationale advanced for these cases, that there was no real indebtedness, only *collusive* shams, has no application to the instant case where collusion has been negatived.) Taking into account the findings of the instant case, the only valid conclusion is that petitioner's right to buy United States government obligations on credit, like any other citizen, is being abridged because the Tax Court and the Court of Appeals deem it unfair, or unpatriotic, to allow petitioner the exceptional tax benefit to which he is entitled under the law as written by Congress.

As was so aptly stated in the *Fabrecka Prods.* case, supra: "Granted the Government's proposition that these taxpayers have found a hole in the dike, we believe it one that calls for the application of the Congressional thumb, not the Court's".

The Court of Appeals' decision not only endorses the Tax Court's errors, but it is irregular on its own account

in that it ignores the Tax Court's finding that petitioner did not know about the mechanics of the transaction. Rejecting petitioner's contention that since neither he nor any representative of his was apprised by the lenders of the short sale procedure and that there was no collusion in such sale, the sale could not be treated as his, the Court quoted from the opinion of the Court of Appeals, Second Circuit, in *Lynch* v. *Commissioner*, supra, at 872, as follows:

> "Save in those instances where the statute itself turns on intent, a matter so real as taxation must depend on objective realities, not on the varying subjective beliefs of individual taxpayers. Beyond this, it would strain credulity to the breaking point to suppose that taxpayers had no inkling that something highly unusual was going on."

The foregoing quotation may have been apt in a case like *Lynch*, where the evidence permitted no reasonable inference but that the transactions were collusive. For example, no securities were ever purchased for the taxpayer in *Lynch;* the purchases and ownership of securities existed on paper only. In any other context, the Court's reference to "objective realities overriding the taxpayer's intent" must be untenable to the point of pure absurdity. Borrower and lender are independent contractors. To impute the "objective realities" of what one does, in his independent capacity, to the other, is fuzzy thinking, tantamount to saying that when one person buys property, another person sells it to him and as an "objective reality" nothing of legal significance has occurred because the sale neutralizes the purchase.

As for the point in the *Lynch* case concerning the taxpayer's knowledge, there was no finding in that case, as there was in the instant case, that the taxpayer did not

know about the mechanics of the transaction. This finding is wholly warranted by the evidence in the instant case and was binding on the appellate court. The petitioner herein was in no way in privity with Mr. Lynch and what the latter may have done or known cannot abridge this petitioner's rights to buy securities, to borrow the purchase money and to deduct interest paid on his purchase money indebtedness. Moreover, the *Stanton* case, with its parallel borrowings from five different banks, shows that what may have strained the Court of Appeals' credulity is really quite ordinary and usual. The risk-free quality of the securities, virtually the equivalent of dollars, dictated the terms of the transaction and underwrites their legitimacy. The terms were carried out in scrupulous detail.

On the record, petitioner may not be treated differently than any other purchaser of government securities, say Stanton, no matter how great or how unusual is the benefit petitioner may derive under the law. That he has been, is due to a series of plain inconsistencies and contradictions, and such a disregard of controlling principles, as to call for the exercise of this Court's power of supervision.

CONCLUSION

For the foregoing reasons this petition should be granted.

November 22, 1961.

Respectfully submitted,

JEROME B. ROSENTHAL
Counsel for Petitioner
250 N. Canon Drive
Beverly Hills, California

BERNARD SPEISMAN
711 Fifth Avenue
New York 22, N. Y.
Of Counsel

APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

No. 17128

ALBERT GORDON MACRAE and SHEILA MACRAE,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Judgment

Upon petition to review a decision of the Tax Court of the United States

This cause came on to be heard on the Transcript of Record from the Tax Court of the United States and was duly submitted

On consideration whereof, it is now here ordered and adjudged by this court that the petition to review is granted to the limited extent of remanding the case to the Tax Court for a redetermination of deficiency for the taxable year 1953, in the light of the opinion of this court.

(Endorsed) Judgment
Filed and Entered August 28, 1961

FRANK H. SCHMID, *Clerk*

Opinion in *Gordon MacRae and Sheila MacRae* v. *Commissioner*. *Albert Gordon MacRae and Sheila MacRae* v. *Commissioner*

TAX COURT OF THE UNITED STATES

Docket Nos. 61091, 67789. 34 TC —, No. 2.
Filed April 12, 1960.

Bernard Speisman, Esq., and Jerald S. Schutzbank, Esq., for the petitioners. Mark Townsend, Esq., and Michael P. McLeod, Esq., for the respondent.

FORRESTER, *Judge*: Respondent has determined deficiencies and an addition in the income tax of petitioners for the calendar years 1952 and 1953 as follows:

Year	*Deficiency*	*Addition Sec. 294(d)(2)*
1952	$ 23,998.38	
1953	109,768.42	$6,172.19

Petitioners raise no separate contentions with respect to the addition for 1953; consequently, the sole issue remaining is the deductibility of certain purported interest payments.

FINDINGS OF FACT

The stipulated facts are so found.

At all times material petitioners have been husband and wife residing in Beverly Hills, California. Their joint income tax returns for the calendar years 1952 and 1953 were filed on the cash basis with the director of internal revenue at Los Angeles. Gordon MacRae, also known as Albert Gordon MacRae, will be referred to as the petitioner.

Petitioner is a well-known entertainer. Prior to the years in question he had made no substantial investments in securities. His business and financial matters were handled for him by his attorneys.

B. Gerald Cantor has at all times material been president of Cantor, Fitzgerald & Co. (hereinafter called "C-F"), brokers and dealers in securities. In December of 1952, Cantor and petitioner's attorneys discussed the possibility that some of the latters' clients might purchase substantial face amounts of United States Treasury Notes (hereinafter called "Notes") with a minimal down payment, using borrowed funds for the bulk of the purchase price.

Shortly thereafter, one of petitioner's attorneys advised him that he could purchase $1 million in Notes primarily with borrowed money, and that the interest on the loan would be a "good tax deduction." Petitioner was further advised that a profit reportable as a capital gain was possible, and that the loan could be made on a nonrecourse basis.

Petitioner did not seek further details. He did not know nor did he inquire as to the interest rate required on the loan, the rate of return on the Notes, or the possibility of profit or loss on the entire transaction apart from tax considerations. His principal purpose in agreeing thereto was the creation of a deduction for tax purposes.

On December 19, 1952, with settlement date of December 26, petitioner placed with C-F an order to purchase for his account 1⅜ per cent Notes, maturing March 15, 1954, in the face amount of $1 million. The confirmation slip of C-F showed the price as $992,500, with accrued interest of $3,874.31. Thereupon, petitioner (1) issued a check

in the amount of $3,874.31, which C-F received on or about December 26, 1952, and (2) executed and delivered to C-F his promissory note in the amount of $992,500, dated December 26, 1952, and due March 15, 1954, with interest at 2½ per cent per annum.

Petitioner's note was without personal liability. It was limited to the collateral security, consisting of the Notes. It provided that petitioner might sell the Notes at any time, and discharge the indebtedness by payment of the net proceeds received. He might also anticipate payment by paying additional interest of ½ per cent per annum prorated to the maturity date of March 15, 1954. The note contained the following provision:

> "The undersigned has paid the interest, due and to be due hereunder, concurrently with the execution hereof, and hereby gives obligee a lien against the securities pledged for the principal amount of the indebtedness set forth herein, and obligee may re-hypothecate or borrow the said securities, provided, however, that such re-hypothecation or borrowing shall not be inconsistent in any manner with the ownership by the undersigned of said securities. Undersigned shall have the right to obtain the return of said securities in kind at any time upon tender of payment of the principal indebtedness due hereunder."

When petitioner placed his above order with C-F, the latter had no Notes in inventory. On December 26, 1952, C-F went through the mechanics of both buying and selling $2 million in such Notes, which amount included the $1 million ordered by petitioner. At the close of business on

December 26, 1952, C-F's inventory did not include any Notes.

The transaction whereby C-F bought and sold the Notes was as follows: C-F arranged a purchase from and sale to C. F. Childs (hereinafter called "Childs"), a dealer in securities, to be effected the same day. Carl M. Loeb, Rhoades & Co., Inc. (hereinafter called "Rhoades") acted as clearance agent. Pursuant to instructions from C-F, Rhoades received the Notes against payment to Childs, and on the same day redelivered them to Childs against payment from the latter. C-F was charged a clearance fee and any differential between the purchase and sale prices.

The sale to Childs constituted a "borrowing" by C-F of the Notes in accordance with the above quoted provision of petitioner's note, a common practice among dealers and brokers in securities.

On December 26, 1952, petitioner issued to C-F a check in the amount of $30,257.42, purportedly as interest to March 15, 1954.

The Gibraltar Financial Corporation (hereinafter called "Gibraltar") was incorporated on or about December 24, 1952. Initial working capital consisted of $1,500 in borrowed money and $2,000 of capital investment paid in on December 29, 1952. No further capital was invested in Gibraltar at any time pertinent.

For the period December 24 to December 31, 1952, Gibraltar's records reflect loans to customers in the amount of $17 million, with another $17 million in such loans for the following month. The first such loan, in the amount of $1,020,000, is recorded as being made December 26, 1952. All "loans" listed on Gibraltar's books during the period

here in issue arose through transactions similar to those of petitioner, as hereinafter described.

Gibraltar's balance sheet was as follows on the dates shown below:

THE GIBRALTAR FINANCIAL CORPORATION

BALANCE SHEET

ASSETS	*December 24, 1952 (Date of Incorporation)*	*December 1, 1953*
Cash in Banks	$2,000.00	$ 23,913.88
Notes and Accounts Receivable		126,609,919.61
Securities Owned—		
Long		20,158.68
Other Assets		1,084.53
	$2,000.00	$126,655,076.70
LIABILITIES		
Accounts Payable		$ 15,706.75
Accrued Expenses—		
Taxes		17,058.42
Securities Borrowed		126,623,456.20
Capital Stock	$2,000.00	2,000.00
Deficit		(3,144.67)
	$2,000.00	$126,655,076.70

On or about January 26, 1953, petitioner's purported loan owing to C-F was refinanced through Gibraltar, petitioner executing a new note. Under its terms, Gibraltar was substituted for C-F as payee, the nonrecourse feature was eliminated, the interest rate was reduced from 2.5 per cent to 2.42 per cent, the amount of the "loan" was increased from $992,500 to $1,020,000 (face value of the Notes plus interest coupons), and the right to a refund of a portion of interest upon prepayment was eliminated.

On the same day, petitioner issued his check to C-F, as correspondent for Gibraltar, in the amount of $27,930.11, purportedly as interest to March 15, 1954, on the new note. At the same time, he received a check from C-F in the amount of $28,082.08, as refund of interest on cancellation of the old note.

Under the terms of the new note, the $1 million in Notes was pledged as collateral security. In accordance with this arrangement, petitioner directed C-F to deliver the Notes to Gibraltar against payment of $1,020,000. C-F did not then have the Notes, and the transfer of the Notes and liability was accomplished by book entries of C-F and Gibraltar.

On August 12, 1953, petitioner purported to sell the Notes to C-F at a total price of $1,001,891.98, including accrued interest in the amount of $5,641.98. He authorized C-F to receive the Notes from Gibraltar against payment, and on the same day instructed Gibraltar to deliver the Notes to C-F against payment.

Pursuant to petitioner's instructions, Gibraltar placed an order with Guaranty Trust Company of New York (hereinafter called "Guaranty") dated August 12 with settlement date of August 13, 1953, for $1 million in Notes at

a total purchase price, including accrued interest, in the amount of $1,002,204.48, to be delivered to Irving Trust Company (hereinafter called "Irving") as clearance agent. At the same time, Gibraltar instructed Irving to receive the Notes from Guaranty against payment of $1,002,204.48, and to deliver $1 million in Notes to the Chemical Bank & Trust Company (hereinafter called "Chemical") as clearance agent for C-F against payment of $1,001,891.98.

At the same time as it agreed to purchase $1 million in Notes from petitioner, C-F also arranged to sell the Notes to Chemical in two lots of $500,000 each. C-F instructed Chemical as clearance agent to receive $1 million in Notes from Irving, which was acting as Gibraltar's clearance agent, against payment of $1,001,891.98, and to deliver the same amount in Notes to the bond department of Chemical against payment of $1,002,126.36.

As a result of the foregoing, Gibraltar and C-F were charged by their respective clearance agents with the clearance fee and the difference between the buy and sell prices. The only substantial monies or credit utilized belonged to the clearance agents, whose willingness to use their funds or credit was attributable to the fact that they had instructions to deliver as well as to receive against payment, and that, apart from the comparatively nominal clearance fee and difference between buy and sell prices, no risk existed.

On March 10, 1953, petitioner entered into a transaction as follows:

On March 10, with settlement date of March 11, petitioner ordered C-F to purchase for his account $2 million face amount 1¾ per cent Federal Land Bank Bonds (hereinafter called "Bonds") due October 1, 1955-1957, and to deliver them to Gibraltar against payment of $1,925,555.56,

the price of C-F's purchase. Thereupon, petitioner executed and delivered to Gibraltar his full-recourse promissory note in the amount of $2,104,000, bearing interest at the rate of 4¼ per cent per annum, payable October 1, 1955, and renewable to October 1, 1957, with interest at the rate of 2¼ per cent per annum for any such extended period.

The note recited that petitioner had pledged the Bonds with Gibraltar as collateral security, and that $178,444.44 of the principal amount of the note would be withheld as security for interest, to be released as interest payments were made. Prepayment to September 1, 1955, was permitted at the rate of 1½ per cent from date of prepayment to maturity.

On March 10, 1953, C-F arranged a purchase of $2 million face amount of Bonds from Childs with settlement date of March 11, at a price of $1,924,305.56, and instructed Chemical as clearance agent to receive the Bonds against payment. On the same day, C-F instructed Chemical to deliver the Bonds against payment in the amount of $1,925,555.56 to Irving as clearance agent for Gibraltar. In turn, Gibraltar instructed Irving to receive the Bonds from Chemical against payment of $1,925,555.56 and to deliver them on the same day to Childs against payment of $1,923,680.56.

As a result of the foregoing, C-F and Gibraltar were charged clearance fees and the difference between the respective buy and sell prices. Two million dollars face amount of Bonds were bought from and sold to Childs on the same day, and neither C-F nor Gibraltar ever actually received possession thereof.

On August 13, 1953, and October 30, 1953, petitioner entered into essentially similar transactions involving $1 million face amount U. S. Treasury Notes 1¾ per cent due

December 15, 1955, and $1 million face amount U. S. Treasury Notes 1½ per cent due April 1, 1958, respectively. Petitioner executed and delivered to Gibraltar full-recourse notes similar to that covering the Bond transaction, in the respective principal amounts of $1,043,250 with interest at 2⅞ per cent and an interest reserve of $54,178.96, and $1,067,000 with interest at 2¾ per cent and an interest reserve of $94,554.95. Subsequent to the taxable years in issue petitioner closed out these transactions as well as that respecting the Bonds in essentially the same manner as already described with respect to the Notes.

During 1952 and 1953, petitioner issued checks to C-F, purportedly as interest payments, as follows:

Checks issued by petitioner, Gordon MacRae, during the years 1952 and 1953 to Cantor, Fitzgerald & Co., Inc., and deducted in the 1952 and 1953 income tax returns.

Date	Check Number	Total Amount	ALLEGED LOANS DATED Dec. 26, 1952	Jan. 26, 1953	Mar. 11, 1953	Aug. 13, 1953	Oct. 30, 1953	Miscellaneous
1952								
Dec. 26	2079	$ 30,257.42	$ 30,257.42					
Total Claimed in Return		$ 30,257.42	$ 30,257.42					
1953								
Jan. 26	2259	$ 27,930.11		$27,930.11				
26	Refund	(28,082.08)	(28,082.08)					
Mar. 9	2396	11,599.77			$ 11,599.77			
June 4	2735	11,599.77			11,599.77			
Aug. 12	3034	28,474.29				$28,474.29		
12	Refund	(14,285.34)		(14,285.34)				
26	3079	11,599.77			11,599.77			
Dec. 4	3420	11,599.77			11,599.77			
17	3464	69,598.62			69,598.62			
23	3491	2,631.43					$2,631.43	
Miscellaneous Adjustment		(33.99)						$(33.99)
Total Claimed in Return		$132,632.12	$ (28,082.08)	$13,644.77	$113,397.70	$28,474.29	$2,631.43	$ (33.99)

The first check, in the amount of $30,257.42, dated December 26, 1952, was received by C-F for its own account. The remaining checks were received for the account of Gibraltar.

In 1953 petitioner received various amounts from C-F, both on its own and on Gibraltar's account, purportedly as interest, a refund of interest, the balance due on a sale of notes, and a refund of excess loan funds.

Petitioner reported $34,094.82 in his 1953 return as interest income, and $1,562.50 as 50 per cent of capital gain upon sale of the Notes.

The original note of petitioner dated December 26, 1952, was without recourse because petitioner was concerned over a note of such size. Thereafter his legal and business advisers were able to assure him that in reality no risk existed, and all later notes were with recourse. This recourse feature permitted a slightly lower rate of interest, but its principal purpose was to strengthen petitioner's legal position in the event the deductibility of purported interest payments should be challenged.

Gibraltar did not at any time have possession of any Notes or Bonds, and consequently did not receive interest thereon. Its books do not reflect such interest receipts, but do credit petitioner with the amount of interest which he would have received as a holder.

Petitioner at no material time intended to borrow money from C-F or Gibraltar, or to purchase securities with their assistance. Nor did C-F or Gibraltar ever intend to lend any amount to petitioner. The intent and purpose of all parties concerned was the creation of a deduction for tax purposes, through a transaction which in form would ap-

pear to create an indebtedness but which in fact was lacking in substance.

OPINION

After careful review of the foregoing facts, we find the instant proceeding indistinguishable in principle from *Eli D. Goodstein*, 30 T. C. 1178 [Dec. 23,152], affd. 267 F. 2d 127 (C. A. 1) [59-1 USTC ¶ 9474]. Cf., also, *Knetsch* v. *United States*, 272 F. 2d 200 (C. A. 9) [59-2 USTC ¶ 9767], certiorari granted February 23, 1960; *Danny Kaye*, 33 T. C. — (filed December 16, 1959) [Dec. 23,891], on appeal (C. A. 9); *George G. Lynch*, 31 T. C. 990 [Dec. 23,456], affd. 273 F. 2d 867 (C. A. 2) [60-1 USTC ¶ 9161]; *W. Stuart Emmons*, 31 T. C. 26 [Dec. 23,201], affd. sub nom. *Weller* v. *Commissioner*, 270 F. 2d 294 (C. A. 3) [59-2 USTC ¶ 9667]; *Broome* v. *United States*, 170 F. Supp. 613 (Ct. Cl., March 4, 1959) [59-1 USTC ¶ 9290]; *Haggard* v. *United States*, an unreported case (D. Ariz., February 17, 1959) [59-1 USTC ¶ 9299].

To be sure, formal appearances have been given more artistic attention in the instant case than in any prior proceeding, and petitioners rely heavily on this greater perfection of form. We discern no difference in substance, however. The results in the cited cases were obtained because the substance of each of the respective transactions differed from its form; petitioners here are not aided because this divergence is even greater in their case.

Petitioners may prevail only if the payments in question were in fact and in substance interest, i.e., consideration paid for the use or forbearance of money. Cf. *Deputy* v. *DuPont*, 308 U. S. 488 [40-1 USTC ¶ 9161]. The only money used here belonged to the banks acting as clearance agents.

These funds were used for a short period (less than 1 day), and the banks were paid in full therefor, when they received their clearance fees. Gibraltar, the alleged recipient of most of the so-called interest payments, had no money, and neither it nor C-F forebore or permitted the use thereof, as a result of the "financial round robins" in which the parties engaged. Cf. *Broome* v. *United States*, *supra*.

To be sure, each step taken, if viewed separately, constituted a normal business activity, similar to many real and substantial transactions consummated on any given business day. But we may not thus fragmentize the transactions here under consideration and view each step thereof as though independent of those which went before and those which followed.

On any normal day of business some persons will buy and others will sell securities. Persons will borrow to effect purchases, and dealers and brokers will hold securities as collateral and, when necessary, borrow securities so held to cover short sales. Lending institutions normally lend many times their actual capital.

But these observations lose significance in the context of the transactions now before us. The steps taken, each in itself a legitimate commercial operation, were here each mirror images, and add up to zero. The various purchases and sales, each real *without the other*, neutralize one another and fairly shout to the world the essential nullity of what was done. No purchase and no sale is essentially identical with what was done here, i.e., identical and virtually simultaneous purchases and sales. The choice of the more complicated and involved method of doing nothing had no purpose, save the erection of the facade upon which petitioners now seek to rely.

We think appropriate here the following language from the opinion of the Court of Appeals for the First Circuit affirming our decision in *Goodstein, supra*, at page 131:

> "Moreover, we are convinced that following the transactions of October 27, 1952, there existed no indebtedness from the taxpayer to Seaboard. Despite the transitory possession by the Guaranty Trust Company of the Treasury notes for Livingstone's account who was acting as the taxpayer's agent, there was never in substance either a purchase of the notes by the taxpayer or borrowing of the purchase funds from Seaboard. However, it would seem that these transactions did create a legal relationship between the taxpayer and Seaboard, but it was not one of borrower and lender. Rather the net result of these transactions was the exchange of promises of future performances between the taxpayer and Seaboard. The taxpayer promised to pay Seaboard a certain preascertained sum of money on March 15, 1954 or at any time before that date which he may select. Seaboard in return promised to acquire and deliver to the taxpayer on the date so selected $10,000,000 face value of 1⅜% United States Treasury notes maturing on March 15, 1954 with interest accrued from the date of the contract."

Petitioners urge that they had no actual knowledge of the mechanics of the transactions as undertaken by C-F and Gibraltar, and we believe this to be true. We disposed of this point in the *Goodstein* case by the following language at page 1188:

> "We think it obvious from the whole record that all the steps taken were pursuant to a preconceived plan

which lacked substance and which was entered into solely to form the basis for a claimed tax benefit. The actual purchase by Livingstone of $10,000,000 face amount of Treasury notes was consummated only to give color to the transaction, and, as pointed out, these notes were disposed of immediately. We think it apparent that it was the intention of all the three participants that the petitioner would not purchase the Treasury notes, that there would be no actual loan to the petitioner, and that he would not pay any interest. He did not risk any borrowed money. The only amount he actually paid out and risked was the $15,000.

"The petitioner, in an attempt to show that he was not party to a pre-arranged plan, testified that he did not give an order for the sale of the Treasury notes, and that he did not know of the sale at the time it occurred. However, the evidence shows that he did, in preliminary conferences, discuss the proposed transaction with M. Eli Livingstone, including the tax consequences, and that in his note given to Seaboard he authorized Seaboard to use the securities. Accordingly, any action taken must be considered to have been at least with his acquiescence."

In any event, regardless of petitioners' ignorance of the actual steps taken, they may deduct the amounts in question as interest only if they were in fact paid as interest on an existing indebtedness, which they intended in good faith to create. These payments do not fit such description. They were in reality the net consideration paid not for a loan, but for a tax deduction, and so viewed are plainly outside of the statute permitting a deduction for interest paid on

an indebtedness. Cf. *W. Stuart Emmons, supra,* where we said at page 31:

> "In the case at bar we might well paraphrase some of the statements of the Supreme Court in the *Gregory* case. Thus, section 23(b) requires a payment for the use or forbearance of money, and not a payment in pursuance of a plan (the creation of an interest deduction) having no relation to the purported result, the purchase of an annuity. The real payment here was not the alleged interest; it was the net consideration, i.e., the first year's premium plus the advance payment of future premiums plus the purported interest, less the 'cash or loan' value of the policy. And the benefit sought was not an annuity contract, but rather a tax deduction of that part of the gross outlay designated for that purpose as 'interest.' Petitioner did not seek an annuity, and in fact gave up all substantial rights of an annuitant in order to reach his true goal, deductions in an amount large enough to reduce his taxes in a sum greater than the net consideration or cost to him of the entire operation."

Petitioners correctly note that the interest deduction does not require a business or profit motive or purpose. It does, however, require a payment of interest on an existing indebtedness, and the contention thus begs the very point in issue.

Had petitioners in fact borrowed money for a vacation, or for any other purely personal purpose, they would clearly be entitled to a deduction for any interest paid on such loan, and we do not understand respondent to contend

otherwise. We must first, however, determine whether petitioners in fact incurred a bona fide indebtedness regardless of their reasons for doing so. We are forced to conclude in the light of the entire record that they did not.

Petitioners did not purport to borrow funds for personal reasons, but rather in respect of hard-headed commercial transactions for profit. They acted within the formal framework of such premise, and it is in the light of the nature of the transactions as claimed by them that we must determine the reality or lack of it in what they did.

Petitioners here purported to enter into a profit-seeking transaction. Yet under the circumstances, no reasonable chance existed of realizing a profit, apart from the "tax gimmick" feature of the transactions, the very aspect in which they were originally presented to and found acceptable by petitioners. It is for this reason that we conclude that the transactions in question, the reality of which may be sustained only on the theory that they were commercial undertakings for profit, were shams, and must be disregarded for tax purposes. Accordingly, respondent's determination is here sustained. Cf. *L. Lee Slayton*, 34 T. C. — (filed April 7, 1960) [Dec. 24,122].

Petitioners now seek, in the alternative, deductions for their net expenditures as losses under section 23(e)(2) of the Internal Revenue Code of 1939.[1] As authority, they

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[1] SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(e) Losses by Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

* * * * *

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

cite the Court of Appeals in the *Goodstein* case, which reversed our decision on this issue.

In *Goodstein* the fourth paragraph of the petition reads in part as follows:

> "c. If the said interest payments are not deductible, the Commissioner erred in failing to allow the sum of $14,722.02 as a loss deduction in the computation of petitioners' taxable income for 1952."

No such provision appears in either of the petitions filed here. The point was first raised in petitioners' supplemental brief. Manifestly, the issue was not properly pleaded, and we may not now consider it.

Respondent's present position with respect to the principal issue is to ignore the disputed transactions entirely for tax purposes, both as to income and expense. For protective purposes, he did not in the notice of deficiency delete from petitioner's income certain items which should be eliminated under his present theory, which we believe sound. Accordingly,

Decisions will be entered under Rule 50.

Opinion on Review

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

No. 17,128 Aug. 28, 1961

ALBERT GORDON MACRAE and SHEILA MACRAE,
Petitioners,

—vs.—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of the Decision of the Tax Court of the United States

Before HAMLEY, JERTBERG and MERRILL, Circuit Judges.
JERTBERG, Circuit Judge.

Before us is a petition for review of a decision of the Tax Court of the United States, reported at 34 T.C. 20. The petitioners are husband and wife who filed joint returns on the cash basis for the taxable years 1952 and 1953. The husband, Albert Gordon MacRae, will hereinafter be called the taxpayer.

The Tax Court sustained the disallowance by the Commissioner of Internal Revenue of amounts paid by taxpayer, claimed by him to represent payments of interest on indebtedness, and hence deductible within the meaning of Section 23 of the Internal Revenue Code of 1939,[1] in the

1 Internal Revenue Code of 1939:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

* * * * *

"(b) Interest.—All interest paid or accrued within the taxable year on indebtedness. * * *"

(26 U.S.C. 1952 ed., Sec. 23.)

computation of taxpayer's net income for the years 1952 and 1953.

The Tax Court determined and ordered a deficiency in income tax for the taxable year 1952 in the amount of $23,998.38, and a deficiency for the taxable year 1953 in the sum of $78,584.32, and an addition to tax under Section 294(d)(2) of the Internal Revenue Code of 1939 in the amount of $4,301.14.

The taxpayer urges that the Tax Court erred in holding that the prepayments [claimed by taxpayer to represent payments of interest on indebtedness] on asserted loans for the purchase and carrying of United States Treasury Notes and Federal Land Bank Bonds did not represent "interest • • • on indebtedness," and hence were not deductible. In the alternative, the taxpayer contends that the Tax Court erred in not allowing his out-of-pocket costs as an ordinary loss in a transaction entered into for profit under Section 23(e)(2),[2] or as a capital loss under Section 117(g)(2)[3] of the Internal Revenue Code of 1939.

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2 Internal Revenue Code of 1939:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

• • • • •

"(e) Losses by Individuals. In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

• • • • •

"(2) if incurred in any transaction entered into for profit though not connected with the trade or business; or • • • "

(26 U.S.C. 1952 ed., Sec. 23.)

3 Internal Revenue Code of 1939:

"Sec. 117. [As amended by Sec. 216 (c), Revenue Act of 1950, c. 994, 64 Stat. 906] Gains and Losses from Short Sales, etc.—

• • • • •

"(g) Gains and Losses from Short Sales, etc. For the purpose of this chapter—

• • • • •

"(2) gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as short term capital gains or losses; and • • • "

(26 U.S.C. 1952 ed., Sec. 117.)

Opinion on Review

The facts, as stipulated and as found by the Tax Court, are not assailed by the taxpayer. They are reported in 34 T.C. 20. We see no reason for extending this opinion by including them here. In short, the facts reveal a plan devised by a firm of brokers and dealers in securities designed to create sizeable "interest" deductions for high-bracket taxpayers whose principal purpose in agreeing to the plan is to create tax deductions. We recently reviewed a variant of the plan devised by the same firm, in *Kaye* v. *Commissioner of Internal Revenue* (9th Cir. 1961), 287 F. 2d 40, wherein we affirmed the decision of the Tax Court [33 T.C. 511], by relying on the teachings in *Knetsch* v. *United States* (1960), 364 U.S. 361. Variants of a broadly similar plan devised by a Boston broker and dealer in securities were likewise decided against the taxpayers in *Becker* v. *Commissioner of Internal Revenue* (2d Cir. 1960), 277 F. 2d 147; *Lynch* v. *Commissioner of Internal Revenue* (2d Cir. 1959), 273 F. 2d 867; *Goodstein* v. *Commissioner of Internal Revenue* (1st Cir. 1959), 267 F. 2d 127; *Sonnabend et al.* v. *Commissioner of Internal Revenue* (1st Cir. 1959), 267 F. 2d 319; and *Broome* v. *United States* (Court of Claims, 1959), 170 F. 2d 613.

The Tax Court concluded that the transactions set forth in the findings of fact did not give rise to any purchases of Treasury notes or Federal Land Bank bonds for the taxpayer and did not involve any real indebtedness on his part or any payments or receipts of real interest, and that the payments made by taxpayer were in reality consideration for tax deductions, not for loans, hence, not deductible under Section 23(b). In essence, this is the same conclusion reached in the several above cited cases.

Taxpayer contends that the Tax Court erred in reaching such conclusion, and endeavors to distinguish the instant case from the above cited cases, on the ground that the

taxpayer was unaware of the mechanics employed by the lenders to finance the loans made to taxpayer. In brief, neither the taxpayer nor any representative of his was apprised by the lenders of the short selling procedure employed by them, and which were made by the lenders for their own account without collusion on the part of the taxpayer, and thus not attributable to the taxpayer. We find no merit in taxpayer's contention. As stated in *Lynch* v. *Commissioner of Internal Revenue*, *supra*, at page 872:

> "Save in those instances where the statute itself turns on intent, a matter so real as taxation must depend on objective realities, not on the varying subjective beliefs of individual taxpayers. Beyond this, it would strain credulity to the breaking point to suppose that taxpayers had no inkling that something highly unusual was going on."

In any event, regardless of taxpayer's contention, deductions of payments made as interest may be deducted only if they are in fact paid as interest on an existing indebtedness. We agree with the reasoning and the result reached by the Tax Court under the facts of this case.

Taxpayer's alternative contentions relate only to a claimed loss deduction in the taxable year of 1953 for his out-of-pocket costs in connection with the transactions above mentioned. Two different theories under which taxpayer claims to be entitled to deduct these out-of-pocket expenses are advanced. First, taxpayer argues that the deduction is authorized under Section 23(e)(2), *supra;* second, that the loss was attributable to his failure to exercise privileges or options to buy or sell property within the meaning of Section 117(g)(2), *supra*.

The Commissioner contends that we should not consider on this appeal such alternate grounds because they were

not raised in the pleadings before the Tax Court. Taxpayer attempted to raise the ground under the first theory by supplemental motion to the Tax Court after the hearings before the Tax Court had been concluded but before the announcement of decision. We recognize the general rule that new issues may not be raised after the hearing by the Tax Court in the absence of good reason therefor. *Vogel's Estate* v. *Commissioner of Internal Revenue* (9th Cir., 1960), 278 F. 2d 548. On this subject see *Hormel* v. *Helvering* (1941), 312 U.S. 552. In that case the Court stated, at page 557:

> "There may always be exceptional cases or particular circumstances which will prompt a reviewing or appellate court, where injustice might otherwise result, to consider questions of law which were neither pressed nor passed upon by the court or administrative agency below. See *Blair* v. *Oesterlein Machine Co.*, 275 U.S. 220, 225."

We think this case fits this exception. The claimed deduction for out-of-pocket losses arises out of the same transactions which were considered by the Tax Court. No new fact issues are presented, and it is not necessary to go beyond the findings of the Tax Court to consider the propriety of the claimed deduction. The Commissioner is not prejudiced, nor has he been denied the opportunity to present arguments against allowance thereof. Under these circumstances, we believe that justice requires that we pass upon the merits of taxpayer's contentions.

In our view, these out-of-pocket losses are not properly deductible under Section 23(e)(2). To allow such out-of-pocket expenditure as a loss incurred in a transaction entered into for profit would be inconsistent with our affirmance of the Tax Court holding that the transactions here

involved were not in substance purchases of securities with borrowed money entered into for profit, but were in reality attempts to simulate such security transactions for the purpose of artificially creating tax deductions.

While the transactions here involved created no "indebtedness" recognizable under Section 23(b), we are aware of the fact that various legal rights and obligations were created. Courts dealing with variants of the plan involved in the present case were also aware of the creation of such legal rights and obligations. Thus in *Goodstein* v. *Commissioner of Internal Revenue*, *supra*, the court stated:

> "However, it cannot be denied that this amount was actually expended by the taxpayer in connection with a transaction which, although it did not result in the purchase of Treasury notes or the borrowing of money, did create a bilateral contract between himself and Seaboard [the lender]." 267 F. 2d, p. 132.

And in *Lynch* v. *Commissioner of Internal Revenue*, *supra*, the court stated at page 870:

> "When the week's work was completed, what was left was this: Each taxpayer was out of pocket in the sum of $29,114.61, the excess of the alleged prepayment of $117,677.11 'interest,' item (4), over the repayment of $88,562.50 by which the 'loan' exceeded the purchase price of the Notes, item (7). Each taxpayer had a contractual right to require Gail [the lender] to deliver the $650,000 of Treasury Notes described in item (2) against payment of $653,250, with a further right to anticipate payment on the terms stated in item (3). In other words taxpayers for their payment of $29,114.61 had obtained a call on Gail for these Notes. * * *"

Thus, in *Becker* v. *Commissioner of Internal Revenue* (2d Cir., 1960), 277 F. 2d 146, it was held that out-of-pocket losses of the taxpayer in a transaction similar to the one here involved clearly fitted the language of Section 117(g)(2) in that they came about from the failure of taxpayer to call in Notes from the lender and cancel the indebtedness. We agree with the court in *Becker* that out-of-pocket losses are clearly "attributable to the failure to exercise privileges or options to buy or sell property", within the meaning of Section 117(g)(2).

In our view, taxpayer is entitled to claim a deduction for out-of-pocket losses in relation to transactions which were terminated in the taxable year 1953. Since the Tax Court did not purport to determine the amount of such out-of-pocket disbursements, taxpayer's petition to review is granted to the limited extent of remanding the case to the Tax Court for a redetermination of deficiency for the taxable year 1953 in the light of this opinion.

(Endorsed) Opinion Filed Aug. 28, 1961.

FRANK H. SCHMID, Clerk.

Opinion in *L. Lee Stanton and Helen La Fetra Stanton* v. *Commissioner*

FINDINGS OF FACT AND MAJORITY OPINION

Docket No. 68914. 34 TC —, No. 1. Filed April 7, 1960.

Hugh Satterlee, Esq., 30 Broad Street, New York, N. Y., and Rollin Browne, Esq., for the petitioners. Emil Sebetic, Esq., for the respondent.

The Commissioner determined income tax deficiencies against the petitioners of $117,054.16 for 1952 and $232,678.86 for 1953. The principal issues for decision are whether the Commissioner erred in disallowing deductions for each year for interest paid on indebtedness and whether interest income was received when noninterest bearing notes were sold. Alternative errors were alleged.

Findings of Fact

The petitioners, husband and wife, filed their income tax returns for 1952 and 1953 with the director for the second district of New York. They kept their books and filed their returns on a calendar year cash basis.

Lee has been a member of the New York Stock Exchange for 36 years and is a partner in the brokerage firm of Carlisle & Jacquelin. He reported "Adjusted Gross Income" of $254,507.79 for 1952 and of $376,281.30 for 1953. His income, at least since 1950, has been subject to very high tax rates. He took this into account in making his personal investments and sought transactions which would give him the greatest net income after taxes. One such type investment was the purchase of large amounts of short-term Government notes or commercial paper at a substantial discount, financing the purchase through ordinary bank loans secured by the purchased notes and selling them at a profit before maturity but after holding them six months. The excess of the amount realized over cost would be reported as a long-term capital gain and the interest on the

borrowed funds would be claimed as a deduction. The net interest received on the obligations would be taxable as ordinary income. The excess of the interest paid on the borrowed funds over the interest, if any, on the obligations would thus be offset in whole or in part by capital gain and in any event there would be a tax benefit because the interest deduction would wipe out high rate taxable income and the capital gain would be taxed at only 25 per cent.

Lee purchased $9,000,000 principal amount of noninterest bearing financial notes of Commercial Investment Trust, Inc. at market from Salomon Bros. & Hutzler as shown in the following table:

Purchase Date	*Prin. Amt.*	*Price Paid*	*Maturity*
12/11/52	$2,000,000.00	$1,974,750.00	7/ 1/53
12/11/52	3,000,000.00	2,962,312.50	6/30/53
12/11/52	1,000,000.00	987,312.50	7/ 2/53
12/16/52	3,000,000.00	2,964,562.50	6/23/53
		$8,888,937.50	

Lee borrowed money from three New York banks and gave his own 3 per cent promissory notes in the full amounts as security for the loans. Three per cent was the current rate on such loans. The following table shows the dates of the loans and personal notes, the amounts of each, the maturity and the lender:

Date	*Amount*	*Maturity*	*Lender*
12 11 52	$1,974,750.00	6/25/53	Hanover Bank
12/11/52	2,962,300.00	6/25/53	Hanover Bank
12 11 52	987,312.50	7/ 2/53	Marine Midland
12 16 52	2,964,562.50	6/23/53	Guaranty Trust
	$8,888,925.00		

The C. I. T. notes which Lee purchased were delivered to the banks for Lee's account against payment by the banks for his account of the purchase prices of those notes. The loans were secured solely by the C. I. T. notes and Lee's personal notes.

Lee anticipated that the interest he would have to pay on the loans would exceed the gain he would have on the notes but he would have a net gain after taxes from the transaction.

Lee paid $144,032.37 interest on his four notes to maturity in December 1952, as required by the lenders, and claimed that amount on his 1952 return as a deduction for interest paid. The Commissioner, in determining the deficiency for 1952, disallowed that deduction and merely stated that it was not deductible under section 23 of the Internal Revenue Code of 1939.

Lee sold the $9,000,000 of the C. I. T. notes at market before their maturity, as shown in the following table:

Sale Date	*Prin. Amt.*	*Sale Price*
6/26/53	$2,000,000.00	$1,999,097.22
6/26/53	3,000,000.00	2,998,916.67
6/26/53	1,000,000.00	999,458.33
6/19/53	3,000,000.00	2,998,916.67
		$8,996,388.89

Each lending bank received from the purchaser the sales price of the C. I. T. notes held by it, applied part of it to pay off Lee's notes held by the bank and paid the balance to Lee. Lee paid the Hanover bank in June 1953 additional interest of $411.42 on his promissory notes for the one day past maturity which they were held by that bank, and in

that same month he received $493.66 from Marine Midland Trust and $988.19 from Guaranty Trust, representing refunds or rebates of interest to maturity which he had prepaid on his promissory notes held by those banks for the period from the date of payment of the principal of those notes to the date of maturity of each. The additional interest paid was claimed as a deduction and the refunds reported as income on the petitioners' 1953 return. The Commissioner made no adjustment with respect to those amounts.

The excess of the amount received from the sale over the cost of the C. I. T. notes, was reported on the petitioners' income tax return for 1953 as a long-term capital gain. The Commissioner, in determining the deficiency for 1953, added to the reported income $107,805.94, with the explanation that it was interest income from the C. I. T. notes and was not includible in the sales proceeds of the notes. He eliminated $107,801.73 from long-term gain and showed the transaction to have resulted in a net long-term capital loss of $4.21.

Lee purchased at market $5,000,000 principal amount of U. S. Treasury notes bearing interest at 1½ per cent maturing on March 15, 1955, and having accrued interest thereon at the date of purchase, as shown in the following table:

Date Purchased	Purchased From	Price	Cost	Accrued Interest
6/24/53	J. [illegible] & Co.	[illegible]	[illegible]	$ 1[illegible]53
6/24/53	J. [illegible] & Co.	[illegible]	[illegible]	[illegible]
6/29/53	The Wisconsin Nat. Bank [illegible]	[illegible]	[illegible]	1,[illegible]07.18
6/24/53	J. [illegible] & Co.	[illegible]	[illegible]	[illegible]
6/24/53	[illegible] & Co.	[illegible]	[illegible]	[illegible]
7/1/53	Harris Trust & Sav.	[illegible]	[illegible]	[illegible]
			$5,[illegible]03,906.25	$21,[illegible]11.01

Lee borrowed $5,000,000 from four banks and gave his own 3½ per cent promissory notes in like amounts as security for the loans. The loans were to become due on March 15, 1955. Three and one-half per cent was the current rate on such loans. The following table shows the lender, the dates of the loans and notes and the amounts of each:

Lender	*Date*	*Amount*
Mercantile National Bank of Chicago	6/26/53	$ 800,000
Lakeview Trust & Savings Bank of Chicago	6/29/53	600,000
First Wisconsin National Bank of Milwaukee	6/30/53	2,400,000
	(6/25/53	500,000)
First National Bank of Baltimore	(6/29/53	500,000)
	(7/ 2/53	200,000)

Lee expected that his profit on the sale of the notes would exceed the excess of the interest on his borrowings up to the date of sale over the net interest on the Treasury notes to that same date by a substantial amount.

The Treasury notes which Lee purchased were delivered to the banks for Lee's account against the payment by the banks for his account of the purchase price of those notes. The $56,387.50 excess of the loans over the cost of the Treasury notes was remitted by the banks to Lee. Lee, at the time of giving his promissory notes, paid interest thereon in the total amount of $151,830.77. Coupons on the Treasury notes came due on September 15, 1953. The banks retained the proceeds of those coupons.

Lee sold the $5,000,000 of Treasury notes at market to Wm. E. Pollock & Co., Inc. as shown in the following table:

Sale Date	*Prin. Amount*	*Sale Price*	*Accrued Int.*
2/ 3/54	$ 800,000.00	$ 802,250.00	$ 4,707.18
2/ 3/54	600,000.00	601,687.50	3,530.29
6/25/54	2,400,000.00	2,413,875.00	10,271.74
2/ 3/54	500,000.00		
2/ 3/54	500,000.00	1,203,375.00	7,060.77
2/ 3/54	200,000.00		
		$5,021,187.50	$25,570.08

Lee's promissory notes were paid off from the proceeds of the sales at the time of the sales. Lee paid to each of the lending banks in 1954 as additional interest on his promissory notes the accrued interest which he received upon the sale of his Treasury notes, and he also paid in 1954 to the First Wisconsin National Bank $13,500 as additional interest on his promissory note held by that bank.

Lee was charged interest of $189,330.77 on his promissory notes during 1953 against which was applied $15,855.99, the net interest received by the banks on the Treasury notes so that the net interest charged against Lee, paid by him and claimed as a deduction on his return, all for 1953, was $173,474.78.

Lee was charged interest of $57,070.08 on his promissory notes during 1954 against which was applied $43,570.08 interest received by the banks on the Treasury notes in that year, resulting in net interest of $13,500 charged against Lee in 1954 and paid by him in that year and claimed as a deduction on his return for that year.

The excess of the amount realized from the sale of the Treasury notes over their cost, both amounts exclusive of accrued interest, was reported as a long-term capital gain on the petitioners' 1954 return.

The Commissioner, in determining the deficiency for 1953, added $15,855.99 to the reported income with the explanation that it was interest income from the 1½ per cent Treasury notes and disallowed the deduction of $173,474.78 taken for interest paid, merely stating that it was not deductible under the provisions of section 23 of the Internal Revenue Code of 1939.

Lee expected at the time he entered into the Treasury notes transactions that the lending banks would terminate the loans when he chose to sell the Treasury notes and refund to him all unearned interest which they had received on those loans. He had no agreement either with the New York banks which had loaned to him almost $9,000,000 in December 1952 or with the out-of-town banks which loaned him $5,000,000 in the middle of 1953, but the two New York banks had refunded the unearned interest at the time the notes were sold and Lee thought that the out-of-town banks would follow the same practice. However, the out-of-town banks refused to cancel the loans and refund the unearned interest when Lee sought to sell the Treasury notes. He delayed the sales until he negotiated with the banks. He reached compromise agreements with three of them and sold the notes held by them on February 3, 1954. Negotiations with the Milwaukee bank continued, and it was not until June 25, 1954, that they were concluded and the notes sold.

The difference between the quoted bid and offered prices of the Treasury notes at all times material hereto was generally 2 32 but occasionally it was only 1 32. The quoted bid price decline from 98 24 32 on March 16, 1953, to 97 31 32 on June 1, 1953. It gradually rose to 98 14 32 on June 22, 1953, was 98 12 32 on June 29, 1953, and rose

for the first time above par, to 100 1 32 on January 18, 1954. It was 100 9 32 on February 1, 1954, and thereafter generally rose, reaching a high of 100 20 32 on May 3, 1954, after which it fluctuated between 100 19 32 and 100 17 32 until about August 1954, when it started to decline and reached 100 4 32 on December 20, 1954, after which it gradually declined to par in February 1955 and remained there until the maturity date.

Lee would have had a long-term capital gain of $92,093.75 if he had been able to sell all of his $5,000,000 U. S. Treasury notes on February 3, 1954. The excess of the 3½ per cent interest on his loans up to that time over the net interest which he would have received on the Treasury notes up to that date would have been $60,910.47. His capital gain would thus have exceeded net interest by $31,183.28. The action of the banks in refusing to terminate Lee's loans on February 3, 1954, required him to pay to those banks $125,999.69 in excess of the amount which he otherwise would have had to pay. He could find no use for the borrowed money after the sale of the Treasury notes and had none in mind when he borrowed the money.

All stipulated facts are incorporated herein by this reference.

Opinion

Murdock, *Judge*: Lee sold the U. S. T. notes in 1953 and reported for that year on that transaction a long-term capital gain. The Commissioner, in determining the deficiency for that year, taxed the gain as interest instead of allowing it to be included in the sales proceeds of the notes for tax purposes. He eliminated the gain as a long-term capital gain. The Commissioner's action is supported by

the decision of this Court in *F. Rodney Paine*, 23 T. C. 391 [Dec. 20,679]. Cf. *Charles T. Fisher*, 19 T. C. 384 [Dec. 19,335], affd. 209 F. 2d 513 [54-1 USTC ¶9212], certiorari denied 347 U. S. 1014, and *Arnfeld* v. *United States*, 163 F. Supp. 865 [58-2 USTC ¶9692]. The *Paine* case was reversed by the Court of Appeals for the Eighth Circuit, one Judge dissenting, see 236 F. 2d 398 [56-2 USTC ¶9749], but the grounds on which it was reversed are not present in this case.

The petitioners argue that our decision in *George Peck Caulkins*, 1 T. C. 656 [Dec. 13,000] affd. 144 F. 2d 482 [44-2 USTC ¶9416], is in direct conflict with our decision in the *Paine* case, but this Court in the *Paine* case explained how the two are distinguishable. The grounds given there for distinguishing the *Paine* and *Caulkins* cases would likewise apply to distinguish the present case from the *Caulkins* case. Cf. *Commissioner* v. *Morgan*, —— F. 2d —— (12-11-59) [60-1 USTC ¶9141], reversing 30 T. C. 881 [Dec. 23,086]. The Commissioner's determination on this issue has not been shown to have been in error.

The only other issue that need be decided is whether the Commissioner erred in disallowing deductions for 1952 and 1953 for interest paid in those years on indebtedness. Section 23(b) of the Internal Revenue Code, applicable to all years involved herein, provides that in computing net income there shall be allowed as a deduction

> "All interest paid * * * within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter."

No contention is made or could be made that the exception quoted above applies here, nor does section 24(a)(6) apply. Those are the only exceptions to the general rule allowing the deduction of "all interest paid * * * on indebtedness." Congress having enacted the only exceptions it desired to make, the maxim of interpretation, "Inclusio unius est exclusio alterius" applies, i.e., Congress intended no other exception or limitation on the deductibility of interest on indebtedness. All interest paid within the taxable year on genuine indebtedness of any other kind thus entitles a cash basis taxpayer to a deduction of the amount of interest paid. The Commissioner here concedes, as he must, "the reality and validity of the series of transactions." Thus the payments of principal and interest were enforceable. Cf. *W. S. Gilman*, 18 B. T. A. 1277 [Dec. 5856], affd. 53 F. 2d 47 [2 USTC ¶801]; *William Park*, 38 B. T. A. 1118 [Dec. 10,493], affd. 113 F. 2d 352 [40-2 USTC ¶9557]. Congress has indicated that this deduction is not dependent in any other way upon the purpose or motive of the borrower, or the use made of the borrowed funds. Lee borrowed the money here involved for a purpose not prohibited by any provision of the Code and is entitled to the deductions claimed.

$56,387.50 of the borrowed money was not used to buy the Treasury notes. Actually, Lee did not use the rest of it for any evil, immoral or illegal purpose, if that makes any difference. Congress has included no requirement in the Code that the borrowed money be used in connection with a transaction entered into for profit or that it cannot be borrowed for personal or nonbusiness purposes or used in a transaction involving tax benefits, cf. *Commissioner* v. *Park*, 113 F. 2d 352 [40-2 USTC ¶9557], and the Tax Court has no authority to write or read such requirements into the law.

The legislative history of section 23(b) shows that Congress has repeatedly considered and ultimately rejected limitations somewhat comparable to the one now urged by the Commissioner. The House, for example, proposed to restrict the interest deduction in the 1924 Act to interest paid or incurred in carrying on a trade or business and other interest which, when added to nonbusiness losses, exceeded tax-exempt interest received. The Senate struck this out and inserted a limitation on indebtedness incurred or continued for the purpose of evading the payment of taxes when the purchaser carried tax-exempt securities other than certain U. S. obligations. But the reference to "indebtedness incurred or continued for the purpose of evading the payment of taxes" was stricken out in conference. The House proposed another limitation for the 1926 Act, but again the Senate refused and the House concurred. The 1932 Act broadened the restriction to deny deduction for interest on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity. The House proposed to broaden the restriction in the 1934 Act, but the Senate refused and also struck out all reference to annuities. The House at the same time proposed in section 24(a)(5) to disallow any deduction allocable to any class of income wholly exempt from tax, but the Senate amended to preclude the application of this provision to the deduction for interest and the House accepted the amendment. See also Revenue Act 1921, section 206(a)(3) and (4), and Revenue Act 1924, section 208(a)(3), (5) and (6), which imposed certain restrictions afterwards dropped from the law and never re-enacted. Cf. section 24(a)(5) and (6) of the 1939 Code.

The Internal Revenue Code imposed heavy taxes upon Lee and he sought a legal way within the provisions of the Code to make a profit for himself after taxes, the only

kind of profit which can do any taxpayer any good. His Treasury note transactions would have been profitable before taxes, if events had happened as he anticipated they would at the time of entering into the transactions. He had reasons, which seemed sufficient to him at the time, to believe that the out-of-town banks would allow him to terminate his loans with the return to him by the banks of the unearned interest at any time he chose to sell the Treasury notes and pay off his bank loans, as the New York banks had done. A deduction for the actual interest which he paid over the term of the loans could not have been denied to him, if that had happened. The taxability of the excess of the amount realized from the sale of the Treasury notes in 1954 over their cost is not an issue in this case, but it was a transaction entered into for profit, and which resulted in a profit, if that is material here. What reason is there for penalizing Lee and deviating from the plain words of the Internal Revenue Code merely because the unexpected action of the banks wiped out Lee's real gain by requiring him to pay about $126,000 of additional interest?

All of Lee's borrowings involved herein were genuine and resulted in real indebtedness within the meaning of section 23(b). There was no collusion. The lenders actually advanced the money borrowed for Lee's use. The money was used in the outright purchase of securities at market. The securities became the property of Lee. They were held as security by the lenders of the money. Lee had all the benefits and risks of ownership. All dealings were "at arm's length." Once he entered into the transactions he was required to do all that he did do, and no step which he took was lacking in substance or legal effect. He was strictly within the law at all times, and the interest deductions which he took for 1952 and 1953 were in exact accordance

with the express provisions of section 23(b). The Commissioner concedes all of this. How then does the Commissioner attempt to justify his disregard of the plain provisions of the Internal Revenue Code whereby he taxes interest received and capital gains on the transactions but denies deductions for all interest paid? He says:

> "This Court has already approved determinations of respondent comparable to the one at issue herein. Cf. *Eli D. Goodstein* (1958) 30 T. C. [1178], No. 124 [Dec. 23,152], aff'd (CA-1, 1959) —— F. 2d —— [59-1 USTC ¶9474], 3 A. F. T. R. 2d 1500; *Abraham M. Sonnabend*, T. C. Memo. 1958-178 [Dec. 23,183(M)], aff'd per curiam (CA-1, 1959) —— F. 2d —— [59-1 USTC ¶9475], 3 A. F. T. R. 2d 1505; *John Fox*, T. C. Memo. 1958-205 [Dec. 23,270(M)]; *Matthew M. Becker*, T. C. Memo. 1959-19 [Dec. 23,441(M)]; *George G. Lynch* (1959) 31 T. C. [990], No. 98 [Dec. 23,456] (On appeal); *Leslie Julian* (1959) 31 T. C. [998], No. 99 [Dec. 23,457] (On appeal); *Egbert J. Miles* (1959) 31 T. C. [1001], No. 100 [Dec. 23,458] (On appeal); See also *W. Stuart Emmons* (1958) 31 T. C. [26], No. 4 [Dec. 23,201] (On appeal [59-2 USTC ¶9667]). Respondent submits that the principles applied in the above decisions are controlling and dispositive of the case at bar.
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> • • • • •
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> "In the light of the foregoing discussion, respondent submits that as a matter of substantial commercial reality, Stanton did not purchase any CIT Notes and Treasury Notes, incur any indebtedness, pay any interest, or sell any CIT Notes and Treasury Notes, which were significant or recognizable for tax purposes. *George G. Lynch, supra; Egbert J. Miles, supra; W. Stuart Emmons, supra.*"

The facts in each of the cited cases distinguish it from the present case. The *Emmons* case bears no resemblance to the facts here. The leading case cited is *Goodstein*, but important differences rob it of all effect as an authority here. The alleged *Goodstein* transactions were collusive shams throughout arranged by Eli Livingstone.[1] The Treasury notes were "purchased" and "sold" practically as one transaction in which no real money passed on behalf of the taxpayer. The alleged lender corporation had no money to lend. No Treasury notes were held as security or otherwise by that corporation. Goodstein was not the owner of any Treasury notes during the time the "loan" was supposed to be in effect. He was not entitled to receive and did not receive the benefit of any interest on Treasury notes. There was no indebtedness of $10,000,000. The whole matter of "interest" was merely an empty bookkeeping device to create the illusion of indebtedness, interest and long-term capital gain. However, the Court in affirming the *Goodstein* case, 267 F. 2d 127 [59-1 USTC ¶9474], expressed the thought that Goodstein, despite the recognized shams, might be entitled to a deduction for some loss in a later year not before the Court. See also *Lynch* v. *Commissioner*, —— F. 2d —— (12-17-59) [60-1 USTC ¶9161], affirming the *Lynch* and *Julian* cases, *supra*, both of which involved similar shams arranged by Livingstone.

The Commissioner quotes language from the Tax Court opinion in the *Miles* case to the effect that "if petitioner did purchase the bonds and incur an indebtedness he did so but for one reason, to realize a tax deduction" and that being so, the interest was not deductible within the intend-

1 Statements in dissents hereto that Livingstone had something to do with this case are improper inferences from Stanton's testimony which I alone heard.

ment of section 23(b). That part of the opinion was not necessary in denying the deduction since the facts disclosed a repetition of the collusive shams in the *Goodstein* case. The Court of Appeals for the Second Circuit, in affirming the *Lynch* and *Julian* cases, did not rely on any such reasoning and did not rely upon *Gregory* v. *Helvering*, 293 U. S. 465 [35-1 USTC ¶9043], which, it said, "the government construes as establishing a doctrine forbidding generally the recognition for tax purposes of transactions entered into for the sole purpose of tax avoidance." It relied instead "on the more fundamental ground" that there was no genuine indebtedness. The *Goodstein*, *Julian*, *Lynch* and *Miles* cases were all correctly decided on the "fundamental ground" that there was no real indebtedness in any of them but merely collusive shams to create a supposed appearance of indebtedness on which supposed interest was paid. Anything contrary to the holding here was not necessary in the *Lynch*, *Julian* and *Miles* cases and is not binding in this case although those cases and the *Goodstein* case were correctly decided on their own facts.

Knetsch v. *United States*, 272 F. 2d 200 [59-2 USTC ¶9767], certiorari granted —— U. S. ——, (2-23-60), decided by the Court of Appeals for the Ninth Circuit, involved a transaction in which the taxpayer purchased 2½ per cent annuity savings bonds from a life insurance company by borrowing the necessary money from the life insurance company at 3½ per cent. The Court affirmed the judgment of the District Court which had held that the amount paid to the insurance company was not interest in fact but the purchase price of a tax deduction. The Court of Appeals said it agreed with the opinion in *Weller* v. *Commissioner*, 270 F. 2d 294 [59-2 USTC ¶9667]. The *Weller* case affirmed 31 T. C. 33 [Dec. 23,202] and also affirmed *W.*

Stuart Emmons, supra. The taxpayers in the *Emmons* and *Weller* cases had purchased annuity contracts and borrowed money from banks to prepay at a discount all future premiums and then received the loan value which the contract would have accumulated up to the time the prepaid premiums would be due. They then used a part of this money to pay off the loans at the banks. *The interest on the bank loans was not in controversy.* The taxpayers were disallowed claimed deductions for "interest" on the amounts they allegedly borrowed from the insurance companies, since no money was in effect loaned to them by the insurance companies. The Court of Appeals for the Fifth Circuit in *United States v. Bond*, 258 F. 2d 577 [58-2 ustc ¶9716], in a situation similar to that involved in the *Knetsch* case, held that the interest on the borrowing from the insurance company was deductible. The payments involved in all of the above four cases were on alleged loans from the insurance companies so that the whole transaction in each case was between the taxpayer and the insurance company. No genuine indebtedness existed on which interest was paid. Such cases are distinguishable factually from the present case. The present taxpayer bought securities on the open market and borrowed money from banks without any collusion to avoid income taxes between him and any person with whom he dealt. His indebtedness was genuine and section 23(b) allows a deduction for interest paid on such indebtedness.

Reviewed by the Court.

Decision will be entered under Rule 50.

(Dissenting opinions are not reprinted)

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In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 570

ALBERT GORDON MACRAE AND SHEILA MACRAE,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 26–45; Pet. 40–56) is reported at 34 T.C. 20. The opinion of the Court of Appeals (Pet. 57–63) is reported at 294 F. 2d 56.

JURISDICTION

The judgment of the Court of Appeals was entered on August 28, 1961. (Pet. 39.) The petition for a writ of certiorari was filed on November 24, 1961. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the courts below erred in holding that so-called payments of interest on so-called loans for the purported purchase and carrying of United States Treasury Notes and Federal Land Bank Bonds did not represent "interest * * * on indebtedness" within the meaning of Section 23(b) of the Internal Revenue Code of 1939 and consequently were not deductible in the computation of the taxpayers' net income.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.
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> * * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The facts of this case involve a plan devised by a firm of brokers and dealers in securities the principal purpose of which is to create sizeable "interest" deductions for high-bracket taxpayers. (Pet. 59.)

The taxpayer[1] is a well-known entertainer. Prior to 1952, he had made no substantial investments in securities. His business and financial matters were handled for him by his attorneys. (Pet. 40–41; R. 27.)

In December 1952 B. Gerald Cantor, president of Cantor, Fitzgerald & Company, Inc. (hereinafter called "C-F"), brokers and dealers in securities, discussed with the taxpayer's attorneys the possibility that some of the latter's clients might purchase substantial face amounts of United States Treasury Notes with a minimal down payment, using borrowed funds for the bulk of the purchase price. Shortly thereafter, one of the taxpayer's attorneys advised him that he could purchase one million dollars in Treasury notes primarily with borrowed money and that the interest on the loan would be a "good tax deduction." The taxpayer was further advised that a profit reportable as a capital gain was possible and that the loan could be made on a nonrecourse basis. The taxpayer did not seek further details. He did not know nor did he inquire as to the interest rate required on the loan, the rate of return on the Treasury notes, or the possibility of profit or loss on the entire transaction apart from tax considerations. His principal purpose in agreeing to the transaction was the creation of a deduction for tax purposes. (Pet. 41; R. 27–28.)

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[1] Albert Gordon MacRae is referred to hereinafter as the taxpayer, his wife being a party only because joint returns were filed for the taxable years (1952 and 1953).

On December 19, 1952, with settlement date of December 26, the taxpayer placed with C-F an order to purchase for his account 1⅜ per cent Treasury notes, maturing March 15, 1954, in the face amount of one million dollars. The confirmation slip of C-F showed the price as $992,500 with accrued interest of $3,874.31. Thereupon the taxpayer issued a check in the amount of $3,874.31, which C-F received on or about December 26, 1952. The taxpayer also executed and delivered to C-F his promissory note in the amount of $992,500, dated December 26, 1952, and due March 15, 1954, with interest at 2½ per cent per annum. The taxpayer's note was without personal liability and was limited to the collateral security, consisting of the Treasury notes. It provided that the taxpayer might sell the Treasury notes at any time and discharge the indebtedness by payment of the net proceeds received. He might also anticipate payment by paying additional interest of ½ per cent per annum prorated to the maturity date of March 15, 1954. The note further recited that taxpayer had paid the interest, due and to be due, concurrently with the execution of the note and gave C-F a lien against the securities pledged for the principal amount of the note. C-F was to have the right to "re-hypothecate or borrow the said securities, provided however, that such re-hypothecation or borrowing shall not be inconsistent in any manner with the ownership" by the taxpayer of the securities. The taxpayer was to have the right "to obtain the return of said securities in kind at any time upon tender of payment of the principal indebtedness due" under the note. (Pet. 41–42; R. 28–29.)

C-F had no Treasury notes in inventory when the taxpayer placed his above-described order with it. On December 26, 1952, C-F went through the mechanics of both buying and selling two million dollars in such Treasury notes, which amount included the one million dollars of notes ordered by the taxpayer. At the close of business on December 26, 1952, C-F's inventory did not include any Treasury notes. (Pet. 42–43; R. 29.)

The transaction by which C-F bought and sold the Treasury notes was as follows: C-F arranged a purchase from and sale to C. F. Childs, a dealer in securities, to be effected the same day. Carl M. Loeb, Rhoades & Company, Inc., acted as clearance agent. Pursuant to instructions from C-F, Rhoades received the Treasury notes against payment to Childs, and on the same day redelivered them to Childs against payment from the latter. C-F was charged a clearance fee and any differential between the purchase and sale prices. The sale to Childs constituted a "borrowing" by C-F of the Treasury notes in accordance with the above-quoted provision of the taxpayer's note. The "borrowing" of securities is a common practice among dealers and brokers in securities. (Pet. 43; R. 29–30.)

On December 26, 1952, the taxpayer issued to C-F a check in the amount of $30,257.42, purportedly as interest to March 15, 1954. (Pet. 43; R. 30.)

On or about January 26, 1953, the taxpayer's purported loan owing to C-F was refinanced through the

Gibraltar Financial Corporation.[2] The taxpayer executed a new note under the terms of which Gibraltar was substituted for C-F as payee, the nonrecourse feature was eliminated, the interest rate was reduced from 2.5 per cent to 2.42 per cent, the amount of the "loan" was increased from $992,500 to $1,020,000 (face value of the Treasury notes plus interest coupons), and the right to a refund of a portion of interest upon prepayment was eliminated. (Pet. 45; R. 31.)

On the same day, the taxpayer issued his check to C-F, as correspondent for Gibraltar, in the amount of $27,930.11, purportedly as interest to March 15, 1954, on the new note. At the same time, he received a check from C-F in the amount of $28,082.08, as a refund of interest on cancellation of the old note. (Pet. 45; R. 31–32.)

Under the terms of the new note, the one million dollars in Treasury notes was pledged as collateral security. In accordance with this arrangement, the taxpayer directed C-F to deliver the Treasury notes to Gibraltar against payment of $1,020,000. C-F

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[2] Gibraltar was incorporated on or about December 24, 1952. Initial working capital consisted of $1,500 in borrowed money and $2,000 of capital investment paid in on December 29, 1952. No further capital was invested in Gibraltar at any time pertinent. (Pet. 43; R. 30.)

For the period December 24 to December 31, 1952, Gibraltar's records reflect loans to customers in the amount of seventeen million dollars, with another seventeen million dollars in such loans for the following month. The first such loan, in the amount of $1,020,000, is recorded as being made December 26, 1952. All "loans" listed on Gibraltar's books during the period here in issue arose through transactions similar to those of the taxpayer, as hereinafter described. (Pet. 43–44; R. 30.)

did not then have the Treasury notes, and the transfer of the Treasury notes and liability was accomplished by book entries of C–F and Gibraltar. (Pet. 45; R. 32.)

On August 12, 1953, the taxpayer purported to sell the Treasury notes to C-F at a total price of $1,001,891.98, including accrued interest in the amount of $5,641.98. The sale was accomplished by virtually simultaneous purchases and sales of identical securities by C-F and Gibraltar, through their clearance agents, in much the same manner as the initial purported purchase. (Pet. 45–46; R. 32–33.) As a result of such actions, Gibraltar and C-F were charged by their respective clearance agents with the clearance fee and the difference between the buy and sell prices. The only substantial monies or credit utilized belonged to the clearance agents, whose willingness to use their funds or credit was attributable to the fact that they held instructions to deliver as well as to receive against payment, and that, apart from the comparatively nominal clearance fee and difference between buy and sell prices, no risk existed. (Pet. 46; R. 33.)

On March 10, 1953, taxpayer entered into a similar transaction with C-F and Gibraltar for the purported purchase of Federal Land Bank Bonds in the face amount of two million dollars. Later in 1953 he made two similar arrangements with the same companies with respect to a total of two million dollars face amount of United States Treasury Notes. The purchases were carried out in the same manner as previ-

ously—by orders by C-F and Gibraltar for the purchase and sale of identical securities on the same day. In each case Gibraltar purported to withhold a substantial amount of the principal amount of the notes as security for interest, to be released as interest payments were made. Subsequent to the taxable years in issue the taxpayer closed out these transactions in essentially the same manner as described above with respect to the Treasury notes purportedly purchased in 1952. (Pet. 46–48; R. 33–35.)

The taxpayer issued to C-F, purportedly as interest payments, checks in the net amount of $30,257.42 during 1952 and $132,632.12 during 1953. These amounts were claimed as interest deductions in taxpayer's returns for 1952 and 1953. (Pet. 48–49; R. 36–37.) During 1953 the taxpayer received various amounts from C-F, both on its own and on Gibraltar's account, purportedly as interest, a refund of interest, the balance due on a sale of notes, and a refund of excess loan funds. (Pet. 49; R. 37.) Such amounts were received a few days after, and in amounts slightly smaller than, taxpayer's payments to C-F. (Pet. 48; R. 36, 146–150.) In his 1953 return taxpayer reported $34,094 as interest income, and $1,562.50 as capital gain from sale of the Treasury notes. (Pet. 49; R. 37.)

Gibraltar did not at any time have possession of any Treasury notes or Bonds, and consequently did not receive interest thereon. Its books do not reflect such interest receipts but do credit taxpayer with the amount of interest which he would have received as a holder. (Pet. 49; R. 37.)

The Commissioner disallowed the claimed interest deductions. (Pet. 40; R. 7–8, 10, 26.) The Tax Court found that the transactions in issue did not create a bona fide indebtedness but were shams, and accordingly sustained the Commissioner's determination. (Pet. 50–55.) The Court of Appeals affirmed. (Pet. 57–62.)[3]

ARGUMENT

The decision below, affirming that of the Tax Court, is controlled by and in accord with this Court's decision in *Knetsch* v. *United States*, 364 U.S. 361. There is no conflicting decision, and no other reason for further review by this Court.

1. Like *Knetsch* v. *United States, supra*, the instant case involves a plan designed to create for a high-bracket taxpayer large "interest" deductions, far in excess of his actual cash investment in the scheme. In *Knetsch* this Court held that an arrangement for the purchase of single-premium annuity bonds was a sham, that no real "indebtedness" had been created under the arrangement, and that Knetsch's purported "interest" payments were not deductible under Section 23(b) of the 1939 Code, *supra*, p. 2, and Section 163(a) of the 1954 Code.[4] The present case is

[3] Another issue, involving deductibility of taxpayer's out-of-pocket costs, was decided in his favor (Pet. 62–63) and is not presented here.

[4] So-called "interest" payments arising out of similar purported annuity contracts were held non-deductible by the courts of appeals in *Emmons* v. *Commissioner*, 270 F. 2d 294 (C.A. 3d), certiorari denied, 364 U.S. 908; *Weller* v. *Commissioner*, 270 F. 2d 294 (C.A. 3d), certiorari denied, 364 U.S. 908; *Diggs* v. *Commissioner*, 281 F. 2d 326 (C.A. 2d), certiorari denied, 364 U.S. 908; *United States* v. *Roderick*, 290 F. 2d 823 (C.A. 5th).

closely analogous, though involving purported purchases of securities issued or guaranteed by the United States. In cases involving similar sham purchases of Government securities, the courts uniformly have denied taxpayers' claims to deductions for "interest" payments where no real indebtedness has been incurred. In such cases, as in this one, the purported securities transactions were accomplished by offsetting book entries based upon virtually simultaneous purchases and sales of identical securities. See *Kaye* v. *Commissioner*, 287 F. 2d 40 (C.A. 9th) (involving arrangements by the same brokerage house which planned and executed the transactions here in issue); *Becker* v. *Commissioner*, 277 F. 2d 146 (C.A. 2d); *Lynch* v. *Commissioner*, 273 F. 2d 867 (C.A. 2d); *Goodstein* v. *Commissioner*, 267 F. 2d 127 (C.A. 1st); *Sonnabend* v. *Commissioner*, 267 F. 2d 319 (C.A. 1st); *Broome* v. *United States*, 170 F. Supp. 613 (C. Cls.).

2. In the present case the taxpayer in form "purchased" United States Treasury Notes and Federal Land Bank Bonds from a broker-dealer with "loans" from the latter and a closely-affiliated finance company at rates of interest, sometimes prepaid, one per cent or more in excess of the interest rate on the securities supposedly purchased. The short-term securities were "purchased" at relatively slight discounts.[8] The Treasury notes and the Bonds sup-

[8] The chance of making a profit from the appreciation of Treasury notes purchased with borrowed funds at the time and on the terms of taxpayer's transaction "would be very low" according to the financial expert who testified for the taxpayer. (R. 251.)

posedly were held by the finance company as security for the loans. In fact, however, the purported "purchases" of securities were handled by virtually simultaneous offsetting orders to buy and sell the same securities. Therefore, neither the finance company nor the broker-dealer ever actually held any securities. (Pet. 41–43, 46–48; R. 28–30, 33–35.) The finance company lacked sufficient funds to make actual loans of the amount it purportedly was lending to the taxpayer. (Pet. 43–44; R. 30–31.) The taxpayer never actually received the principal of the "loans" or the securities supposedly purchased with the "loans," and in fact he could not have obtained either since neither the broker nor the finance company ever had them. (Pet. 41–49; R. 28–35.) Moreover, all the "loans," except one which promptly was refinanced (Pet. 45; R. 31), were made at the par value of the securities plus the interest coupons to accrue (Pet. 45–48; R. 31–35). This enabled the finance company and the broker to refund a high proportion of the taxpayer's "interest" payments promptly in the form of a "refund of excess loan funds," as well as purported interest, refund of interest, and the balance due on a supposed sale of notes. (Pet. 47–49; R. 33–37; 146–150). Thus, whenever the taxpayer made a payment of "interest," he received shortly thereafter a refund in an amount somewhat less than his payment. Consequently the taxpayer had minimal out-of-pocket expense with respect to the large interest deductions which he claimed.

On the basis of these undisputed facts, and the principles enunciated by this Court in *Knetsch*, the

courts below were fully justified in holding that the transactions in issue did not give rise to any real indebtedness or any real payments of interest, but were shams. Taxpayer's contention (Pet. 25–33) that he personally may have been unaware of the details of the transaction, about which he had been generally informed and which he had authorized (R. 77–78), is beside the issue; the crucial fact remains that taxpayer did not actually borrow any money or purchase any securities—and did not intend to do so (Pet. 49; R. 37–38). See *Lynch* v. *Commissioner*, 273 F. 2d 867, 872 (C.A. 2d). As both courts below pointed out (Pet. 53–54, 59–60), whether or not taxpayer knew of the mechanics employed by his agent, the amounts in question are deductible as interest "only if they were in fact paid as interest on an existing indebtedness," and no true indebtedness existed. Here, as in *Knetsch* (p. 366), "there was nothing of substance to be realized by * * * [taxpayer] from this transaction beyond a tax deduction."

3. The decisions upon which taxpayer relies for conflict furnish no support whatever for his position. *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118 (C.A. 2d), upon which he chiefly relies (Pet. 13–16), did not involve the tax effect of a sham transaction, as does the instant case. It was there held that debentures issued by a subsidiary to its parent in payment of a dividend declared out of paid-in surplus—a concededly real transaction—represented a creditor (debt) rather than a proprietary (stock) interest in the subsidiary. Cf. *Gregg Co. of Delaware* v. *Commissioner*, 239 F. 2d 498 (C.A. 2d), certiorari

denied, 353 U.S. 946. The opinion is to be searched in vain for any suggestion that a sham indebtedness—the kind here involved—entitles a taxpayer to an interest deduction.[6] Indeed, the Second Circuit's *Kraft* decision is to be contrasted with the same court's decisions in *Becker* and *Lynch, supra,* which bear a close resemblance to the instant case, and in which claimed interest deductions were disallowed on the ground that no real indebtedness had been created.

As for *Gregory* v. *Helvering,* 293 U.S. 465, and like cases relied upon by taxpayers (Pet. 21–22), they confirm rather than impugn the correctness of the decision below. They stand for the familiar proposition that while a taxpayer may minimize taxes by any lawful means, he may not do so by resorting to sham transactions. See *Knetsch* v. *United States,* 364 U.S. at 365, 367.

Nor is the decision below inconsistent with *Stanton* v. *Commissioner,* 34 T.C. 1, as taxpayer contends (Pet. 19–20). In that case the taxpayer actually borrowed funds from banks and used the loan proceeds to purchase securities on the open market.[7] In the

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[6] Similarly, *Preston* v. *Commissioner,* 132 F. 2d 763 (C.A. 2d), upon which taxpayer also relies (Pet. 17), involved a real indebtedness for monies actually borrowed, not a sham loan.

[7] Taxpayer's reliance (Pet. 22) upon *Maysteel Products, Inc.* v. *Commissioner,* 287 F. 2d 429 (C.A. 7th); *Fabreeka Products Co.* v. *Commissioner,* 294 F. 2d 876 (C.A. 1st), and *Evans* v. *Dudley* (C.A. 3d), decided September 21, 1961 (8 A.F.T.R. 2d 5706), as creating a conflict also is misplaced. In those cases, involving a deduction for amortizable bond premiums, the taxpayers had actually borrowed funds, actually purchased bonds, and assumed the risks of genuine obligations. Thus the facts

present case there was no real borrowing and no real purchase of any securities by or for the taxpayer. The *Stanton* decision is consistent with the holding of the courts below that under the circumstances of this case, involving sham transactions and no actual borrowing, taxpayer did not pay any "interest * * * on indebtedness" and is not entitled to a deduction under Section 23(b).

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.
LOUIS F. OBERDORFER,
Assistant Attorney General.
HARRY BAUM,
NORMAN H. WOLFE,
Attorneys.

DECEMBER 1961.

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are not analogous to those of the present case. Here there was no real borrowing or purchase of securities, but only a series of offsetting actions designed to create "the facade of 'loans'." *Knetsch* v. *United States*, *supra*, p. 366.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 570

ALBERT GORDON MacRAE and SHEILA MacRAE,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR PETITIONERS

JEROME B. ROSENTHAL
Attorney for Petitioners
250 N. Canon Drive
Beverly Hills, Calif.

BERNARD SPEISMAN
Of Counsel
711 Fifth Avenue
New York 22, N. Y.

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REPLY BRIEF FOR PETITIONERS

I. Respondent has dealt only in semantics and avoided the actual issues raised by the petition.

Respondent's brief in opposition to the petition for certiorari herein does not even attempt to contradict petitioner's analysis of the opinions of the courts below, nor does it resolve the various legal questions which arise from the holdings of those courts. Rather, respondent seems anxious to sweep the issues, and petitioner's legal rights, under the carpet, quietly, without due examination by this Court. Petitioner is regretfully forced to this conclusion in view of the misstatements and half-truths which respondent has presented and his reliance on pure semantics in

lieu of rational argument respecting the critical questions of law raised in the petition.

Petitioner's transactions are sham, respondent concludes loftily, therefore the *Kraft Foods* case, 232 F. 2d 118 (C.A. 2), is inapposite, but the *Knetsch* case, 364 U.S. 361, controls. Nowhere does respondent try to deal with the actual language used by the Tax Court in holding petitioner's transactions sham, nor attempt to impugn petitioner's analysis of that language and the legal questions which it raises. Not once does respondent refer to any of the serious discrepancies between this case and the *Stanton* case (34 T.C. 1) which petitioner cited, nor attempt to explain or reconcile these discrepancies.

Respondent has relied on mere semantics in two crucial areas:

A. In the *Stanton* case, respondent blandly asserts, "The taxpayer actually borrowed funds from banks and used the loan proceeds to purchase securities in the open market," whereas "in the present case, there was no real borrowing and no real purchase of any securities." Therefore, the two cases are not inconsistent (Resp. 13-14).

Does respondent mean that only borrowings from banks represent valid indebtedness within Section 23(b)? Wherein does Mr. Stanton's "actual purchase" of bonds differ from the specific purchase of bonds which the petitioner herein directed and which was in fact made by the broker, C-F, in each instance from a regular dealer in such securities—some of the same dealers, in fact, as those from whom Mr. Stanton purchased his securities. Were petitioner's purchases confirmed by the broker C-F to petitioner in any different manner from that in which Mr. Stanton's purchases were confirmed to him, or with any difference in the legal rights of ownership evidenced by such confirma-

tion? What could the *petitioner* have done that *he* did not do? Respondent does not attempt to say: he merely proclaims that petitioner did not purchase securities, etc.

Respondent thus baldly avoids a fundamental question presented by this case. That is whether a short sale effected by a broker or other lender for his own account may be attributed to a borrower whose securities are used by the lender to make delivery against his own short sale, even though the borrower had no knowledge either of the lender's purpose to make a short sale or of the fact of his making the short sale? Only if the short sale may be so attributed at law, can it be said that petitioner did not purchase and own the securities upon which his indebtedness was based.

Respondent obviously begs this crucial question when he merely states as a naked conclusion that there was no real borrowing and no real purchase of securities. That assumption cannot be permitted to stand without examination by this Court, since the legal effect of attributing the lenders' own short sales to the petitioner is tantamount to holding that one party to a contract may, by his independent actions, abridge the ownership and other contractual rights of another party to the contract without the latter's knowledge or consent. Such a "doctrine" is manifestly spurious and unconscionable.

The Tax Court found that petitioner "had no actual knowledge of the mechanics of the transactions as undertaken by C-F and Gibraltar." That finding is unavoidable on the record, and it is controlling. It may not be abridged, as respondent evidently would have it,[1] by innuendo or un-

[1] Petitioner was not in privity with Danny Kaye (287 F.2d, 40, C.A. 9) and the fact that Kaye may have participated in an entirely different type of transaction with the same brokerage house (C-F) cannot abridge petitioner's rights to purchase securities, borrow the purchase price, and deduct the interest paid on his purchase money debt.

warranted association of the petitioner with other taxpayers not in privity with him.

Petitioner himself did nothing different, nothing that is distinguishable in law from that which ever purchaser of securities on credit is obliged to do. He directed the purchase of the securities, he signed notes to cover his borrowings and he gave the lender the right to "rehypothecate or borrow" the pledged securities as every borrower on securities must. Petitioner's business manager, Mr. Norton, reasonably believed that the lenders would rehypothecate the securities with a bank at a lower rate of interest than that paid by petitioner (R. 91), as brokers normally do. He had no reason to suspect, and no way to know, that the lenders intended to sell the securities short. It is a most unusual procedure and it is specious to suppose that a layman could guess it.[2]

Petitioner agreed to pay a higher rate of interest on his loans than the yield he realized on his securities but that is always necessary in borrowing on early maturity securities of the United States, as petitioner proved. The bank or other lender can buy the securities in the open market to obtain the yield for itself and must charge a differential to cover the expense of making the loan (R. 245). Thus, everyone buying these United States Government obligations on credit must sustain a loss in terms of interest cost vs. yield realized.[3] There is no basis for a determination of sham in this or in any other term of the transaction.

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[2] The procedure is in fact so unusual that it may fairly be open to question whether most persons in the brokerage business would have suspected other than that the securities were rehypothecated in the normal manner.

[3] Thus, Stanton paid 3½ per cent on his loans as against the approximately 1½ per cent yield of the securities which he hypothecated.

The Tax Court held the transactions sham not on factual grounds, but on purely legal grounds which respondent has failed even to mention.

B. Respondent has also relied solely on semantics in respect to the conflict between this case and *Kraft Foods*. The *Kraft Foods* case, *supra*, did, indeed, involve different facts from those presented in the instant case, as respondent indicates, but the issue raised by the Commissioner in that case and decided by the Court of Appeals is precisely the same as that on which petitioner's rights have been determined in the instant case. In the *Kraft Foods* case, the Commissioner argued that the taxpayer's debentures might not be recognized as debentures because there was no purpose in their issuance other than tax avoidance. The Tax Court upheld him, but the Court of Appeals reversed. In the instant case, the Tax Court upheld the Commissioner on the same essential ground and the Court of Appeals affirmed (Pet. 16-17). The issue of sham was present in both cases. In the *Kraft Foods* case, with an apparent display of delicacy, the Tax Court made no express reference to "sham," but it asserted that, although the taxpayer had issued valid enforceable evidences of indebtedness, it had not intended to create indebtedness. The Court of Appeals explicitly discussed the element of sham, and its ruling, in effect, eliminated the existence of sham. In the instant case, it is true, petitioner's transactions have been held sham, but only on the basis of a conclusion of law directly contrary to that applied in the *Kraft Foods* case. The conflict between the two cases is plain, direct. That it arises from different facts makes it all the more significant since it indicates the far-reaching implications of the principle enunciated in the instant case.

Respondent's artful semantics cannot erase the conflict between this case and *Kraft Foods* any more than it can

twist the *Knetsch* case into foreclosing the unrelated issue presented by the holding in this case—whether interest paid on indebtedness to purchase and carry United States Government securities is deductible under Section 23 (b) if no reasonable chance existed of realizing a profit on the purchase apart from the tax consequences (Pet. 11-21).

II. Respondent's statements of essential facts distort the issues.

Only by attributing the lenders' independent short sales to petitioner can petitioner's transactions be disregarded. Whether such attribution is proper on the record is the issue before this Court. Respondent has evidently sought to side-step this issue not only by relying on semantics but by presenting half truths and misstatements, which distort the real issues. Specifically:

1. Respondent states: "As both courts below pointed out (Pet. 53-54, 59-60), whether or not taxpayer knew of the mechanics employed by his agent, the amounts in question are deductible as interest 'only * * * '" etc. (Resp. 12). Nowhere in either opinion of the courts below is there any finding or statement that the lenders acted as the "agents" of petitioner in respect to the loans, nor would such a finding be permissible on the record. The relationship between petitioner and C-F and Gibraltar, the two lenders, is governed by petitioner's margin agreement and his notes. The relationship under these documents is that of borrower and lender, each acting for himself alone. It clearly is not that of an agent obtaining funds for the benefit of the borrower from some third party as the lender; C-F and Gibraltar were themselves the lenders and, as such, were principals under the contracts of loan. Respondent's reference to some "agent" is a pure invention, betraying an

evident lack of confidence in his position under the true facts of the case.

So, too, there is no basis for respondent's oblique reference, earlier in the same paragraph, to taxpayer's contention that he was unaware of the "details" of the transaction (i.e., meaning the lenders' short sales) about which, respondent then proceeds to assert, petitioner had been "generally informed and which he had authorized" (R. 77-78). There is nothing in the record at the point cited by respondent, or anywhere else, to indicate that petitioner or his business managers had been generally informed about any short sale or had authorized any short sale by the lenders. On the contrary, every party to the transactions testified that petitioner had not been informed (R. 82, 91-92, 111, 232). The Tax Court's finding that petitioner did not know about the short sale (Pet. 52) is fully warranted by the record and it is controlling.

2. At the very outset, in his Statement, respondent asserts that petitioner did not seek any details of the transaction respecting the interest rate required on the loan, the rate of return on the Treasury notes, etc. (Resp. 3). However, respondent neglects to mention petitioner's testimony on cross examination, that he relied on his business managers (R. 76-77) and that Mr. Norton, one of his managers had, in fact, shown him the figures relating to the transaction (R. 78). Not only is respondent's statement misleading, but its intended implication is altogether irrelevant. Top flight entertainers, like the petitioner, constantly move from one engagement to another in different parts of the country and, as is commonly known, are generally compelled by circumstances as well as by temperament to rely on agents and managers to handle the "details" of their business affairs. That petitioner relied on business

managers to the extent that he did in this transaction is without special significance to his case.

3. At another point, respondent notes that in the refinancing of petitioner's original loan, on or about January 26, 1953, petitioner directed the original lender, C-F, to deliver the Treasury notes to the new lender, Gibraltar, against payment of $1,020,000, but "C-F did not then have the Treasury notes, and the transfer of the Treasury notes and liability was accomplished by book entries of C-F and Gibraltar" (Res. 6-7). Respondent, however, has omitted mention of the testimony of C-F's accountant that since Gibraltar was a correspondent of C-F, it was entirely regular and proper to reflect the dealings between them in their "omnibus," or reciprocal, accounts (R. 167). The expert capacity of this witness was conceded by respondent (R. 183-4) and the testimony has in no way been impugned. In all instances where actual delivery of securities was necessary to petitioner's transactions, such delivery was in fact duly made.

4. Respondent asserts in his argument that, "• • • neither the finance companies nor the broker-dealer ever actually held any securities. • • • The finance company lacked sufficient funds to make actual loans of the amount it purportedly was lending to the taxpayer • • • The taxpayer never actually received the principal of the 'loans' or the securities supposedly 'purchased' with the loans • • •," etc. (Resp. 11). Respondent here ignores the facts of the case and of normal security financing. Brokers normally rehypothecate their customers' securities with banks in order to obtain the funds required: few, if any, are able to finance all of their customers' margin transactions. Petitioner's business representative testified that he anticipated the lenders would rehypothecate petitioners' securities (R. 91). That is the usual procedure and there was no reason

to expect anything else. And, of course, petitioner "never actually received the principal of the 'loans' or the securities." The principal of the loan was applied in payment of his purchase money obligation and petitioner was entitled to get the securities only when the principal of the loan was paid.

Indeed, the facts which respondent cites are in no way new, and they are beside the issues raised in the petition for certiorari. Respondent cited all of these facts in his brief to the Tax Court. It would have been a relatively simple matter for the Tax Court to hold petitioner's transactions sham in fact, as respondent seeks to imply, if such a finding were justified. The Tax Court did not so hold, but conscientiously determined that petitioner's transactions were sham only because (in its estimation) there was no reasonable chance of realizing a profit apart from tax consequences. The Court's carefully formulated statement in this respect is no accident but was necessitated by the facts and the proof, including petitioner's proof demonstrating the regularity of the brokerage practices which respondent questions (R. 259-278).

5. The same considerations apply to respondent's further statements in the same paragraph (Resp. 11), to the effect that all of the loans except one were made at par value plus the interest coupons to accrue, with refunds of a high proportion of taxpayer's interest payments by the lender to petitioner so that, respondent alleges, "the taxpayer had a minimal out-of pocket expense with respect to the large interest deductions which he claimed." Respondent's implication that petitioner did not pay the full amounts claimed as interest deductions is completely unwarranted. Respondent's own statement of the facts shows that petitioner issued his own checks for the various amounts claimed as interest deductions (Resp. 4-8). In-

deed, this was stipulated by respondent. Petitioner has claimed only the amount of interest which he actually paid. Neither the Tax Court nor the Court of Appeals has held otherwise in this case. If respondent chooses to claim that the refunds by the lenders to petitioner represented a refund of interest, it behooves him to point out also that petitioner paid the amounts represented by his notes in full upon the termination of his transaction. This would raise a further question of law for determination in this case. The years 1952 and 1953 are at issue. One of petitioner's transactions was completed in the latter year. Any contention that the "refund of excess loan funds" by the lender was a refund of interest would merely serve to throw some of the interest into the later year, when the transaction was terminated and fully settled. It does not go to the substance of the petition for certiorari. It is not a talisman of sham, as the Tax Court recognized. On the contrary, the fact that the lenders withheld the amount of petitioner's borrowing in excess of the value of the securities, indicates that the lenders acted prudently, and at arm's length, in normal protection of their interests.

CONCLUSION

Respondent has not even attempted to deal with the actual holding in this case and the questions of law which that holding creates as analyzed in the petition for certiorari. Nor has he resolved the conflict between the holding in the instant case and the *Kraft Foods* case, *supra*, as demonstrated in the petition.

The petition for certiorari should be granted in view of this conflict and of the far-reaching implications of the holding in this case that interest on indebtedness is not deductible under Section 23(b) unless the transaction from which it arose provided a "reasonable chance of realizing a profit" apart from the tax consequences. The petition should be granted, also, in consideration of respondent's evident reluctance to appeal the *Stanton* case and resolve the issue while continuing to disallow the interest deduction in similar cases, as shown in the petition. On these and the other grounds presented in the petition for certiorari, the petition should be granted.

Respectfully submitted,

JEROME B. ROSENTHAL
Attorney for Petitioners

BERNARD SPEISMAN
Of Counsel

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 570

ALBERT GORDON MACRAE and SHEILA MACRAE,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR REHEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI

JEROME B. ROSENTHAL
250 N. Canon Drive
Beverly Hills, California

ABE FORTAS
CAROLYN E. AGGER
JULIUS M. GREISMAN
1229 19th Street, N. W.
Washington 6, D. C.

Attorneys for Petitioners

Of Counsel:

BERNARD SPEISMAN
711 Fifth Avenue
New York 22, New York

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR REHEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI

Petitioners pray that this Court grant a rehearing of its order of January 8, 1962, denying a petition for a writ of certiorari, and that a writ of certiorari issue to review the judgment of the Court of Appeals for the Ninth Circuit in this case as prayed for in the petition filed on November 24, 1961.

This petition for rehearing is filed to call to the Court's attention a reason for granting certiorari which was not previously urged and which counsel regard as of significant and, we suggest, determinative impor-

tance: That reason is the necessity for this Court to dispel the existing confusion as to the application of this Court's decision in *Knetsch* v. *United States*, 364 U.S. 361 (1960), in relation to the nondeductibility of interest payments in connection with loans made to finance securities transactions.

By ruling upon this point, in the context of the present case, we believe this Court will avert further conflict, discrimination and injustice in the rulings of the lower courts, as evidenced in part by the conflict between the Tax Court's decision in *Stanton* (April 7, 1960) and in the present case, decided five days later.

This is a matter of great importance to many taxpayers and to the securities business of the nation.

PRELIMINARY

This case involves the deductibility of interest under Section 23(b) of the Internal Revenue Code of 1939. In four different transactions, petitioner[1] placed orders with Cantor, Fitzgerald & Co., herewith referred to as C-F, brokers and dealers in securities, for the purchase of U. S. notes and Federal Land Bank bonds. C-F either loaned the petitioner the funds to acquire them or arranged for petitioner to borrow the funds from a correspondent, Gibraltar Financial Corporation. C-F then bought the securities for petitioner's account. Petitioner executed and delivered promissory notes for the purchase price and prepaid interest on these notes to their maturity. The notes were with recourse.[2]

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[1] Albert Gordon MacRae is referred to hereinafter as the petitioner, his wife being a party only because joint returns were filed for the taxable years involved.

[2] The first promissory note was initially without recourse. It was shortly converted to a recourse note.

The Tax Court described the first note as giving the lender a lien upon the securities pledged as collateral and the right to rehypothecate or borrow the collateral in a manner not inconsistent with MacRae's ownership of the securities. MacRae never gave anyone authority to sell for his account until 19 months after the first purchase.

The transaction was similar to hundreds or thousands of securities transactions that take place every day. The loan was bona fide; petitioner was personally liable for its payment; petitioner ordered the purchase of the securities like any purchaser, and the securities were actually purchased by a registered broker-dealer for his account. This was not a "sham" transaction. There was no "wash-out" so far as petitioner was concerned. He actually borrowed money; he actually bought securities. He did not sell any of the securities until 19 months after the first purchase.

The Tax Court, however, relied upon an event *which has no relation to the taxpayer* and of which the Tax Court itself found *the taxpayer had no knowledge*.[3] This is the fact that C-F, or Gibraltar, *without the knowledge of petitioner* and not for his account sold the securities on the same day that it purchased them.[4]

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[3] The Tax Court opinion states: "Petitioners urge that they had no actual knowledge of the mechanics of the transactions as undertaken by C-F and Gibraltar, and we believe this to be true." 34 T.C. at 27.

[4] The broker sold short similar securities for its own account, borrowing MacRae's securities in that connection, but MacRae knew nothing of the broker's short sale. So far as he knew, the securities were held as collateral for his loan. The sale could not have been made for MacRae's account since he had not authorized it. A customer has no means of preventing a broker from selling

The Tax Court relied upon the immediate sale of the securities to reach its result. It held that the sale of the securities showed that the transaction was an "essential nullity." Then, *despite its finding that the petitioner knew nothing about all this*, the Tax Court used this as the reason for disallowing the deduction to the unknowing petitioner. The SEC apparently regards such a transaction as a loan; once securities are purchased and held for the customer's account against payment, a loan has been made; and an immediate sale by the lender does not nullify the loan. See *Appendix A, infra.*

Obviously, we submit, the principle established by this holding, approved by the Ninth Circuit, is intolerable: It is that a person who borrows from a broker or dealer to effect a purchase of securities is in effect held not to have borrowed the money, because of the latter's wholly unrelated actions—*even if the borrower is ignorant of them.*[5] This principle is not only unjust and unlawful, but if followed, will place a burden upon purchasers of securities which should and will discourage a typical and common form of trading.

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the same securities as are held for his account. See Perry A. Nichols, 37 T.C. No. 74 (1962).

The sale was undoubtedly made to allow the broker to avoid the interest expense which would have been incurred had the notes been rehypothecated and funds borrowed to finance the loan made to petitioner. The short sale permitted the lender to achieve a greater profit on the transaction.

[5] In *Perry A. Nichols, supra*, the Tax Court found the taxpayer chargeable with the broker's or dealer's actions and the loan a "sham," even when the broker expressly represented that he would not sell the taxpayer's securities short, and subsequent correspondence from the dealer erroneously indicated that the securities were being held as collateral for taxpayer's loan.

The Tax Court, as affirmed by the Court of Appeals, also grounds its characterization of the loan as "sham" on the proposition that one engaging in a "commercial transaction," must have a reasonable expectation of profit before taking into account the tax effect of the transaction.[6] The only true economic profit on a transaction is that remaining after taxes. If all loans are to be subjected to the novel test relied upon by the Tax Court, the *MacRae* decision has opened a very broad area of uncertainty in many commercial transactions. Almost every time a person buys U. S. securities on margin he weighs the relative value of the expected capital gain, after taxes, against the net cost of interest, after taxes. Absent the tax effect, many thousands of such margin transactions do not produce profit and are not expected to do so. *MacRae* would make all these transactions "sham."

Accordingly, this case presents the important question whether a transaction which, so far as the taxpayer is concerned, involves a bona fide loan on which interest is bona fide paid, should be treated as a sham because of the action of the broker or dealer, to which the taxpayer was a stranger, and of which he was entirely ignorant, and or because the transaction may have produced a profit only after the application of the tax rates.

The lower courts also relied on *Knetsch* to hold that a loan in this sort of transaction should be so treated.

[6] Petitioner obviously entered to the transactions with the hope of an economic benefit. The expected gain on the disposition of the securities, even after paying capital gains tax, was greater than the net cost of the interest paid—that is after taking account of the cost of net interest (interest paid less interest received) after the deduction of the net interest from taxable income.

We submit that the present case clearly presents the problem of misconstruction and misapplication of *Knetsch*, and that it is of great importance that this Court rule on the questions presented. Even in the very specific area of transactions motivated by and carried out, quite like the present, the question is important, and the lower courts' lack of clarity as to *Knetsch* is leading to conflicting and confusing results. A striking example of this appears upon comparing the Tax Court's decision in *Stanton* with the decision in the present case. See *infra*.

REASONS FOR GRANTING THE WRIT

1. The decision below is a misapplication of the decision of this Court in *Knetsch* v. *United States*, *supra*. There is evidence that this Court itself appreciated that *Knetsch* might require further elaboration.[7] In *Knetsch*, the petitioner himself engaged in a "sham" transaction. He was not really obligated to pay interest, nor did he in reality buy an annuity in anywhere near the amount purportedly involved.[8] This is the point of the decision. The fact that the transaction was tax motivated was expressly "put aside" and was not a basis for the decision.

The lower courts, however, have applied the reasoning of the *Knetsch* decision in a situation like the pres-

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[7] As Justices Douglas, Whittaker, and Stewart pointed out in their dissenting opinion in *Knetsch*, "To disallow the 'interest' deduction because the annuity device was devoid of commercial substance is to draw a line which will affect a host of situations not now before us and which, with all deference, I do not think we can maintain when other cases reach here." 364 U.S. at 371

[8] In *Knetsch*, the taxpayer purported to borrow over $4,000,000 to acquire an annuity which would be worth $1000.

ent case where parties have borrowed to acquire securities, which were undeniably worth what was paid for them, and where the interest was undoubtedly paid and not partially refunded." In other indistinguishable situations the lower courts have allowed the interest deduction. *L. Lee Stanton* v. *Commissioner*, 34 T.C. 1 (1960), appeal dismissed (1961).[10] See also *Hood* v. *Commissioner*, 20 T.C.M. 1140 (1961); and *Sadie S. Friedman* v. *Commissioner*, 34 T.C. 456 (1960).

The present case and the Tax Court's decision in the *Stanton* case illustrate the confusion in the present state of the law on interest deductions.

The lower courts in the present case have characterized the loans as a "sham," because the broker or dealer sold MacRae's securities for their own account—without his knowledge—rather than incurring interest expense themselves on the sums they had advanced to MacRae.[11] So far as MacRae knew, the broker or dealer was holding the securities as his property, pledged as collateral for his loan. In the *Stanton* case, decided for the taxpayer, the only differences in fact

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[9] *Kaye* v. *Comm'r*, 287 F. 2d 40 (9th Cir. 1961); *Perry A. Nichols*, *supra*; and the present case.

[10] The variety of views concerning the proper treatment of the interest deduction is further illustrated by the fact that there were four separate opinions in the Tax Court in the *Stanton* case.

[11] The Tax Court makes something of the circumstance that MacRae's creditors did not have adequate funds to make the loans. There is no basis for assuming that MacRae knew this. In any event, brokers often borrow money to carry the accounts of their customers. There is no reason to believe that the broker or dealer here involved could not have rehypothecated the securities and borrowed on them. However, they obviously could make more money by selling the securities, knowing that they could reacquire them any time they needed them, as they did.

are that Stanton borrowed the money from a bank and not from his broker or a correspondent of his broker (Gibraltar), and the bank, which loaned Stanton the price of his securities with prepaid interest, held the securities as security for the duration of their loan. The latter circumstance is clearly immaterial. The deductibility of interest by borrowers cannot depend upon how lenders handle their affairs. Cf. *Dallas Downtown Development Co.* v. *Commissioner*, 12 T.C. 114 (1949).

There is no rational basis for a distinction between the two situations in the fact that MacRae borrowed from the broker or dealer and Stanton from a bank.[12] In neither case did the borrower receive the cash or possession of the securities, which were collateral for the loan. In both cases the total interest was prepaid. These arrangements are common in securities margin transactions,[13] regardless of the identity of the lender. If the courts regard the identity of the lender as an important factor, or perhaps the determining factor,[14] then money will be borrowed from brokers for margin

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[12] "Surely, the application of the tax laws does not depend upon the source of borrowing." J. Moore, in *Diggs* v. *Comm'r*, 281 F. 2d 326, 332 (2d Cir. 1960), cert. denied, 364 U.S. 908.

[13] ". . . a bank will buy securities for a customer and make a loan against the securities as collateral. The customer usually never sees money or securities." *Diggs* v. *Comm'r*, *supra*, at 331. See also *Kraft Foods Company* v. *Comm'r*, 232 F. 2d 118, 122 (2d Cir. 1956). So will brokers make a loan against the purchase of securities and the customer will not see the money or the securities.

[14] See *Sadie S. Friedman* v. *Comm'r*, *supra*; *Clifford Hood* v. *Comm'r*, *supra*; *John T. Loughran*, 19 T.C.M. 1193 (1960), appeal dismissed (4th Cir. 1961). See also the Commissioner's Brief in opposition to the petition for certiorari, pp. 13-14. In the *Loughran* case, interest was allowed to be deducted which was paid on a bank loan to finance the purchase of an annuity as in *Knetsch*.

purchases of stocks and commodities and similar transactions only at the peril of the borrower. He may find that because of the action of the broker-dealer, unknown to him, he will be denied deductibility of interest. The deductibility of interest paid on the loan is too important in our present income tax system to allow such a result without serious repercussions.

The confusion of the lower courts is made apparent by the irrational and arbitrary variation in results in such cases as the present one and *Stanton* and those cases which follow *Stanton*. Court decisions, in relying upon such meaningless distinctions as the identity of the lender and the completely unrelated conduct of the lender, acting for its own account (even where that conduct was unknown to the taxpayer),[13] have completely lost sight of the basic teaching of *Knetsch*. The determinative factor in *Knetsch* is that the loan there was a "sham" because it did not involve a real payment of interest and was arranged to acquire nothing of realistic value, *not* that the lender was an insurance company rather than a bank.

In the present case, MacRae obtained securities which were worth the amount borrowed and whose sale produced a capital gain. He actually paid the interest on the loan, upon which he was individually liable. This is the transaction, so far as he is involved. The loan was, therefore, no "sham," whether or not we postulate that the petitioner was tax motivated. The *Knetsch* decision itself makes it clear that no consequences attach to the fact that the loan would not have been made except for the variation of the tax rates appli-

[13] The four dissenting Judges of the Tax Court in the *Stanton* case could see no distinction between that situation and *MacRae*.

cable to the deduction for interest payments and the gain on the sale of securities.[16]

2. The urgent need for clarification is emphasized by the present posture of cases of this sort. The *Stanton* case was decided for the taxpayer on April 7, 1960. Five days later the *MacRae* decision was decided for the Commissioner. As demonstrated above, there is no rational distinction between *MacRae* or the very recent *Nichols* decision[17] and *Stanton*. An appeal to the Second Circuit was filed by the Commissioner from the decision in *Stanton*, apparently because the Tax Court decided *Stanton* for the taxpayer in obvious conflict with *MacRae*. But then the Department of Justice dismissed the appeal in Stanton. Presumably the Commissioner now has the hopeless task of ruling upon other cases on the basis of *both Stanton* and *MacRae*! Certainly it would be a boon to all concerned if this Court will now rule on the problem and in so doing, clarify the application of *Knetsch* to this type of situation.[18]

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[16] As Justice Brennan stated, "We put aside a finding . . . that Knetsch's 'only motive in purchasing these 10 bonds was to attempt to secure an interest deduction.'" *Knetsch, et al.* v. *United States*, *supra*, at 365.

As Judge Murdock said in *Stanton*, the profit "after taxes" is "the only kind of profit which can do any taxpayer any good." 34 T.C. at 8.

[17] See n. 4, *supra*.

[18] There may also be a denial of due process in the lower courts' taking into account the unauthorized action of C-F as a basis for denying the interest deduction here. In *Hooper v. Tax Commissioner*, 284 U.S. 206 (1931), this Court invalidated a Wisconsin statute as a denial of due process because it subjected a husband to a tax computed on the combined total of his and his wife's separate incomes. There would seem to be an equal denial of due process if one person is denied a deduction because of the action of a third party taken without the person's knowledge and not for the account of the taxpayer.

3. This Court has granted certiorari to consider the claim that the lower courts have distorted principles announced by its decisions. See *Commissioner* v. *Culbertson*, 337 U.S. 733, 735 (1949), in which the claim was that the lower courts had misapplied its earlier decisions[19] in the family partnership area. See also *Commissioner* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1949) where again the Court granted certiorari to clear up doubts arising from its earlier decision in the *Court Holding Company* case, 324 U.S. 331 (1945). The present misapplication of the holding in *Knetsch* makes this Court's intervention imperative so that the Commissioner's efforts to collect tax will be confined to the statutory limits as interpreted by this Court.

4. The whole question of the deductibility of interest payments is one of major importance in the Federal tax system. At the time of the decision in the *Stanton* case, it was one of 13 similar cases pending in the Tax Court. From an inspection of the Tax Court Docket it is apparent that at least 11 more cases have since been filed in the Tax Court alone; and we understand from a statement of the Respondent made in a motion to defer the trial of this case, that there are many hundreds of cases which have not reached the litigation stage. The present case, presenting, as it does, a situation in which money was borrowed to buy valuable securities, provides an excellent vehicle for clarification of this whole difficult area.

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[19] *Commissioner* v. *Tower*, 327 U.S. 280 (1946); *Lusthaus* v. *Commissioner*, 327 U.S. 293 (1946).

CONCLUSION

For the reasons set forth above and in the petition for certiorari, it is respectfully urged that rehearing be granted and that, upon such rehearing, a writ of certiorari issue to the Court of Appeals for the Ninth Circuit.

Respectfully submitted,

JEROME B. ROSENTHAL
ABE FORTAS
CAROLYN E. AGGER
JULIUS M. GREISMAN
Attorneys for Petitioners

Of Counsel:

BERNARD SPEISMAN

Dated: February 1, 1962.

CERTIFICATE OF COUNSEL

Abe Fortas, one of the counsel for the petitioners herein, hereby certifies that the foregoing Petition for Rehearing is presented in good faith and not for delay and is restricted to grounds specified in Rule 58(2) of the Rules of this Court.

APPENDIX A

Excerpts from Wall St. Journal (January 29, 1962, p. 12) on Public Hearing of the SEC on Charges Against Sutro Bros. & Co.

"Mr. Schwartz told the hearing it would be part of Sutro Bros. defense that the loans made to Sutro Bros. by First Discount were 'unsecured' and that therefore they did not violate securities laws and regulations.

How Transaction Worked

"Mr Schwartz said that when First Discount advanced money to a customer of Sutro for the purchase of stock, the stock was immediately sent to a bank, North Jersey Trust Co., for First Discount's account there. The bank then immediately sold the stock on First Discount's instructions, Mr. Schwartz said. Later, when the customer returned the money he had borrowed, First Discount had to go into the open market to buy the stock which it returned to him, Mr. Schwartz said. 'If the stock had meanwhile gone up, First Discount had a loss. If it had gone down, they made some money,' said Mr. Schwartz. North Jersey Trust Co. is located in Ridgewood, N.J.

"Mr. Schwartz added, 'But First Discount never extended any credit on securities, because they never had any. Just about every stock delivered by Sutro Bros. to First Discounts account at North Jersey Trust Co. was promptly sold. First Discount never had any stock as collateral. They were unsecured loans and in no way a violation of the regulations.'

"John J. Devaney, assistant regional administrator of the SEC, replied at the hearing that so far as the SEC was concerned, "Once Sutro Bros. had delivered securities to North Jersey Trust Co. for the account of First Discount Corp. against payment to Sutro from First Discount, the transaction was closed. *An extension of credit had been given, and what was done with the stock afterwards does not concern this hearing.*'" [Emphasis added]

No question of a violation of the margin regulations is involved in the present case since these regulations are not applicable to U. S. Government securities.